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**UNITED NATIONS COMMISSION ON
INTERNATIONAL TRADE LAW**

YEARBOOK

Volume XXXVIII: 2007



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NOTE

Symbols of United Nations documents are composed of capital letters combined with figures. Mention of such a symbol indicates a reference to a United Nations document.

The footnote numbering follows that used in the original documents on which this *Yearbook* is based. Any footnotes added subsequently are indicated by lower-case letters.

Changes of and additions to wording that appeared in earlier drafts of conventions, model laws and other legal texts are in italics, except in the case of headings to articles, which are in italics as a matter of style.

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INTRODUCTION

This is the thirty-seventh volume in the series of *Yearbooks* of the United Nations Commission on International Trade Law (UNCITRAL).¹

The present volume consists of three parts. Part one contains the Commission's report on the work of its fortieth session, which was held in Vienna, from 25 June-12 July 2007 and from 10- 14 December 2007, and the action thereon by the United Nations Conference on Trade and Development (UNCTAD) and by the General Assembly.

In part two most of the documents considered at the fortieth session of the Commission are reproduced. These documents include reports of the Commission's Working Groups as well as studies, reports and notes by the Secretary-General and the Secretariat. Also included in this part are selected working papers that were prepared for the Working Groups.

Part three contains summary records, the bibliography of recent writings related to the Commission's work, a list of documents before the fortieth session and a list of documents relating to the work of the Commission reproduced in the previous volumes of the *Yearbook*.

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¹ To date, the following volumes of the *Yearbook of the United Nations Commission on International Trade Law* (abbreviated herein as *Yearbook* [year]) have been published:

<i>Volume</i>	<i>Years covered</i>	<i>United Nations publication Sales No.</i>
I	1968-1970	E.71.V.1
II	1971	E.72.V.4
III	1972	E.73.V.6
III Suppl.	1972	E.73.V.9
IV	1973	E.74.V.3
V	1974	E.75.V.2
VI	1975	E.76.V.5
VII	1976	E.77.V.1
VIII	1977	E.78.V.7
IX	1978	E.80.V.8
X	1979	E.81.V.2

<i>Volume</i>	<i>Years covered</i>	<i>United Nations publication Sales No.</i>
XI	1980	E.81.V.8
XII	1981	E.82.V.6
XIII	1982	E.84.V.5
XIV	1983	E.85.V.3
XV	1984	E.86.V.2
XVI	1985	E.87.V.4
XVII	1986	E.88.V.4
XVIII	1987	E.89.V.4
XIX	1988	E.89.V.8
XX	1989	E.90.V.9
XXI	1990	E.91.V.6
XXII	1991	E.93.V.2
XXIII	1992	E.94.V.7
XXIV	1993	E.94.V.16
XXV	1994	E.95.V.20
XXVI	1995	E.96.V.8
XXVII	1996	E.98.V.7
XXVIII	1997	E.99.V.6
XXIX	1998	E.99.V.12
XXX	1999	E.00.V.9
XXXI	2000	E.02.V.3
XXXII	2001	E.04.V.4
XXXIII	2002	E.05.V.13
XXXIV	2003	E.06.V.14
XXXV	2004	E.08.V.8
XXXVI	2005	E.10.V.4
XXXVII	2006	E.11.V.1

Part One

REPORT OF THE COMMISSION ON
ITS ANNUAL SESSION AND
COMMENTS AND ACTION THEREON

THE FORTIETH SESSION (2007)

A. Report of the United Nations Commission on International Trade Law on its fortieth session (Vienna, 25 June-12 July 2007) (A/62/17) (Part I)

[Original: English]

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Annex

List of documents before the Commission at its fortieth session

I. Introduction

1. The present report of the United Nations Commission on International Trade Law (UNCITRAL) covers the first part of the fortieth session of the Commission, held in Vienna from 25 June to 12 July 2007 (see para. 3 below for the decision of the Commission to hold its fortieth session in two parts).
2. Pursuant to General Assembly resolution 2205 (XXI) of 17 December 1966, this report is submitted to the Assembly and is also submitted for comments to the United Nations Conference on Trade and Development.

II. Organization of the session

A. Opening of the session

3. The fortieth session of the Commission was opened on 25 June 2007. At its 837th meeting,¹ on 25 June, the Commission agreed that its fortieth session would be held in two parts. For the agenda and dates of the resumed session, see paragraphs 11 and 247 below.

B. Membership and attendance

4. The General Assembly, in its resolution 2205 (XXI), established the Commission with a membership of 29 States, elected by the Assembly. By its resolution 3108 (XXVIII) of 12 December 1973, the Assembly increased the membership of the Commission from 29 to 36 States. By its resolution 57/20 of 19 November 2002, the Assembly further increased the membership of the Commission from 36 to 60 States. The current members of the Commission, elected on 17 November 2003 and on 22 May 2007, are the following States, whose term of office expires on the last day prior to the beginning of the annual session of the Commission in the year indicated:² Algeria (2010), Armenia (2013), Australia (2010), Austria (2010), Bahrain (2013), Belarus (2010), Benin (2013), Bolivia (2013), Bulgaria (2013), Cameroon (2013), Canada (2013), Chile (2013), China (2013), Colombia (2010), Czech Republic (2010), Ecuador (2010), Egypt (2013),

¹ This number was assigned to the first meeting of the fortieth session in order to align the numbering of Commission meetings with the numbering of summary records of the Commission meetings at its thirty-ninth session (see in particular A/CN.9/SR.835, a summary record of the penultimate meeting of the thirty-ninth session of the Commission). This resulted in a discrepancy with paragraph 12 of the report of the Commission on the work of its thirty-ninth session (*Official Records of the General Assembly, Sixty-first Session, Supplement No. 17* (A/61/17)), which indicates the 834th meeting as the last meeting of that session.

² Pursuant to General Assembly resolution 2205 (XXI), the members of the Commission are elected for a term of six years. Of the current membership, 30 were elected by the Assembly at its fifty-eighth session, on 17 November 2003 (decision 58/407), and 30 were elected by the Assembly at its sixty-first session, on 22 May 2007 (decision 61/417). By its resolution 31/99, the Assembly altered the dates of commencement and termination of membership by deciding that members would take office at the beginning of the first day of the regular annual session of the Commission immediately following their election and that their terms of office would expire on the last day prior to the opening of the seventh regular annual session following their election.

El Salvador (2013), Fiji (2010), France (2013), Gabon (2010), Germany (2013), Greece (2013), Guatemala (2010), Honduras (2013), India (2010), Iran (Islamic Republic of) (2010), Israel (2010), Italy (2010), Japan (2013), Kenya (2010), Latvia (2013), Lebanon (2010), Madagascar (2010), Malaysia (2013), Malta (2013), Mexico (2013), Mongolia (2010), Morocco (2013), Namibia (2013), Nigeria (2010), Norway (2013), Pakistan (2010), Paraguay (2010), Poland (2010), Republic of Korea (2013), Russian Federation (2013), Senegal (2013), Serbia (2010), Singapore (2013), South Africa (2013), Spain (2010), Sri Lanka (2013), Switzerland (2010), Thailand (2010), Uganda (2010), United Kingdom of Great Britain and Northern Ireland (2013), United States of America (2010), Venezuela (Bolivarian Republic of) (2010) and Zimbabwe (2010).

5. With the exception of Benin, Chile, Ecuador, Fiji, Gabon, Guatemala, Israel, Madagascar, Malta, Mongolia, Namibia, Senegal, Sri Lanka and Zimbabwe, all the members of the Commission were represented at the first part of the session.

6. The first part of the session was attended by observers from the following States: Argentina, Azerbaijan, Belgium, Brazil, Cuba, Democratic Republic of the Congo, Dominican Republic, Finland, Hungary, Indonesia, Iraq, Jordan, Kuwait, Libyan Arab Jamahiriya, Panama, Peru, Philippines, Portugal, Qatar, Romania, Slovakia, Tunisia, Turkey, United Republic of Tanzania and Yemen.

7. The first part of the session was also attended by observers from the following international organizations:

(a) *United Nations system*: Economic and Social Commission for Western Asia and World Intellectual Property Organization;

(b) *Intergovernmental organizations*: European Community and International Institute for the Unification of Private Law;

(c) *Non-governmental organizations invited by the Commission*: American Bar Association, American Intellectual Property Law Association, Association française des entreprises privées, Association of Commercial Television in Europe, Association of European Trade Mark Owners, Commercial Finance Association, European Association of Insurance Companies, European Law Students' Association, Federation of European Factoring Associations, Independent Film and Television Alliance, International Bar Association, International Chamber of Commerce, International Swaps and Derivatives Association and International Trademark Association.

8. The Commission welcomed the participation of international non-governmental organizations with expertise in the major items on the agenda. Their participation was crucial for the quality of texts formulated by the Commission and the Commission requested the Secretariat to continue to invite such organizations to its sessions.

C. Election of officers

9. The Commission elected the following officers:

Chairperson: Dobrosav Mitrović (Serbia)

Vice-Chairpersons: Biu Adamu Audu (Nigeria)
Horacio Bazoberry (Bolivia)

Kathryn Sabo (Canada)

Rapporteur:

T. K. Viswanathan (India)

D. Agenda

10. The agenda of the first part of the session, as adopted by the Commission at its 837th meeting, on 25 June 2007, was as follows:

1. Opening of the session.
2. Election of officers.
3. Adoption of the agenda.
4. Adoption of a draft UNCITRAL legislative guide on secured transactions and possible future work.
5. Procurement: progress report of Working Group I.
6. Arbitration and conciliation: progress report of Working Group II.
7. Transport law: progress report of Working Group III.
8. Insolvency law: progress report of Working Group V.
9. Possible future work in the area of electronic commerce.
10. Possible future work in the area of commercial fraud.
11. Monitoring implementation of the 1958 New York Convention.
12. Endorsement of texts of other organizations: Unidroit Principles of International Commercial Contracts 2004.
13. Technical assistance to law reform.
14. Status and promotion of UNCITRAL legal texts.
15. Coordination and cooperation:
 - (a) General;
 - (b) Reports of other international organizations.
16. Willem C. Vis International Commercial Arbitration Moot competition.
17. Relevant General Assembly resolutions.
18. Other business.
19. Date and place of future meetings.
20. Adoption of the report of the Commission.
21. Congress 2007.

11. At its 852nd meeting, on 4 July, the Commission agreed that the agenda of the resumed fortieth session would include agenda item 4 and a separate agenda item entitled “Working methods of UNCITRAL”. During the resumed session, the Commission would also adjust dates of future meetings, as appropriate. (For the dates of future meetings considered by the Commission at the first part of its fortieth session, see paras. 247-252 below.)

E. Establishment of the Committee of the Whole

12. The Commission established a Committee of the Whole and referred to it for consideration agenda item 4. The Commission elected Kathryn Sabo (Canada) Chairperson of the Committee. The Committee met from 25 June to 2 July 2007 and held 12 meetings. At its 849th meeting, on 3 July, the Commission considered the report of the Committee of the Whole and agreed to include it in the present report. (The report of the Committee of the Whole is reproduced in paragraphs 14-157 below.)

F. Adoption of the report

13. At its 853rd and 854th meetings, on 6 July 2007, the Commission adopted the present report by consensus.

III. Adoption of the draft UNCITRAL Legislative Guide on Secured Transactions and possible future work

A. Adoption of the draft UNCITRAL Legislative Guide on Secured Transactions

14. The Committee (see para. 12 above) had before it a complete set of revised recommendations and revised commentaries on the draft UNCITRAL Legislative Guide on Secured Transactions (A/CN.9/631 and Add.1-11) and the reports of the eleventh (Vienna, 4-8 December 2006) and twelfth (New York, 12-16 February 2007) sessions of Working Group VI (Security Interests) (A/CN.9/617 and A/CN.9/620, respectively). It also had before it a note by the Secretariat transmitting comments of the European Community and its member States on the draft Guide (A/CN.9/633). The Committee established a drafting group and referred to it the terminology of the draft Guide (A/CN.9/631/Add.1, para. 19). The Committee expressed its great appreciation to the Secretariat for its work in preparing the documents for the session.

15. The Committee noted that, in view of the need to conclude consultations and make subsequent amendments in the revised commentaries following the conclusion of the twelfth session of the Working Group, some documents had been submitted late and were not available in all language versions at the beginning of the session (specifically A/CN.9/631/Add.1-3, dealing with chapters I-VI). The Committee therefore decided to begin its consideration of the draft Guide with chapter VII, which dealt with the priority of a security right as against the rights of competing claimants.

1. Chapter VII. Priority of a security right as against the rights of competing claimants

(a) Recommendations (A/CN.9/631, recommendations 74-107)

16. With regard to recommendation 84, the Committee noted that it was intended to address the question whether a transferee of an encumbered asset took the asset free of a security right that had been made effective against third parties by

registration in a specialized registry or by notation on a title certificate. While some doubt was expressed as to whether that question should be addressed in recommendation 85 or not at all in the draft Guide, there was sufficient support for the retention of recommendation 84. However, the concern was expressed that it failed to address the transfer of rights other than security rights. In order to address that concern, it was suggested that, following the formulation of recommendation 85 or 93, reference should be made to the transfer of a “right in an encumbered asset” (not of “a security right”) and to “a security right” in that asset (not “the security right”). That suggestion received sufficient support.

17. Noting that a security right registered before it was created was not effective against third parties and that, as a result, no issue of priority arose, the Committee decided to delete recommendation 86, subparagraph (b) (ii).

18. With respect to recommendation 87, subparagraph (a), the concern was expressed that the reference to “inventory or consumer goods” might be confusing, since the same tangible assets could be inventory for the seller and consumer goods for the buyer. In order to address that concern, it was suggested that the reference to consumer goods should be deleted. While the view was expressed that, in a sale from a consumer to a consumer of assets encumbered by a security right created by the seller, the buyer should take the assets free of the security right, there was sufficient support for the suggestion to delete the reference to “consumer goods”. It was stated that a rule providing that a consumer buying an encumbered asset outside the ordinary course of business of the seller would take the asset free of an existing security right could interfere with existing financing transactions involving assets of high value.

19. In addition, with respect to recommendation 87, subparagraphs (a) and (b), it was observed that, as long as reference was made to sales and leases in the ordinary course of business, a reference to the type of asset involved was not necessary and, thus, reference to “tangible property other than negotiable instruments and negotiable documents” (as “tangible property” was defined to include negotiable instruments and negotiable documents (A/CN.9/631/Add.1, para. 19)) would be sufficient.

20. With respect to recommendation 99, the view was expressed that it was ambiguous in its application to securities. In addition, the view was expressed that the fact that the draft Guide addressed security rights in letters of credit and rights to payment of funds credited to a bank account but not in derivatives raised some concern with respect to the rules applying to financial contracts. The Committee decided to defer discussion of those issues until it had had the opportunity to consider the application of the draft Guide as a whole to securities and financial contracts (see paras. 145-151 below).

21. With respect to recommendations 101 and 102, the concern was expressed that they did not sufficiently clarify that priority could be modified by agreement between competing claimants. In order to address that concern, it was suggested that wording along the lines of “unless otherwise agreed” should be added to those recommendations. That suggestion was objected to. It was stated that recommendation 77 was sufficient to clarify that priority could be modified by agreement between competing claimants. It was also observed that the addition of the suggested wording could cast doubt as to whether other priority rules were subject to a contrary agreement between competing claimants.

22. Some doubt was expressed as to whether recommendation 107 was necessary. It was stated that recommendation 106 was sufficient to give priority to rights acquired through due negotiation of a negotiable document under the law governing negotiable documents. However, the Committee agreed that recommendation 107 was necessary in that it went further and dealt with rights acquired without due negotiation of a negotiable document.

23. With respect to the formulation of recommendation 107, general support was expressed in favour of an alternative formulation. Under that formulation the right of a secured creditor, buyer or other transferee of a negotiable document that took possession of the negotiable document would have priority over a security right in the goods covered by the negotiable document, as long as the goods were covered by the document and the secured creditor, buyer or other transferee gave value in good faith and without knowledge that the transfer was in violation of the security right in the goods.

24. However, at the same time, several concerns were expressed with respect to that alternative formulation of recommendation 107. One concern was that it might inadvertently result in defeating a security right in a situation where a grantor, having created a security right in inventory in favour of secured creditor A, placed the inventory in a warehouse, had a warehouse receipt issued and obtained new financing by transferring possession of the warehouse receipt to secured creditor B. In order to address that concern, the suggestion was made that reference should be made to a secured creditor, buyer or other transferee of a negotiable document taking possession of the document in the grantor's, seller's or other transferor's ordinary course of business. Another concern was that the alternative formulation failed to address a conflict between the right of a secured creditor that took possession of the negotiable document and the right of a secured creditor in a negotiable document that was made effective against third parties other than by transfer of possession. In order to address that concern, the suggestion was made that the alternative text should be revised to address that priority conflict. A further concern was that the reference to both good faith and the absence of knowledge that the transfer was in violation of an existing security right was superfluous, as those two notions had the same meaning. In order to address that concern, the suggestion was made that the reference to good faith or the absence of such knowledge should be deleted. Yet another concern was that, unlike other recommendations, recommendation 107 was formulated in a negative way (a right was subordinate to another right instead of having priority over another right).

25. The Committee deferred adoption of recommendation 107, pending its consideration of a revised formulation (see paras. 130-133 below).

26. Subject to the changes mentioned above, the Committee adopted recommendations 74-106.

(b) Commentary (A/CN.9/631/Add.4)

27. The Committee approved the substance of the commentary to chapter VII subject to the following changes:

(a) Paragraph 1, second sentence, should make clear that, for the priority rules to apply, at least one of the competing claimants had to be a secured creditor;

(b) Paragraph 4, first sentence, should refer to security rights that were effective against third parties, and explain with examples the concept of “third-party effectiveness” and its relationship to the concept of “priority”;

(c) Paragraph 5, second sentence, should clarify that no issue of priority could arise between security rights that were not effective against third parties;

(d) Before paragraph 6, the heading “Importance of the priority concept” should be added;

(e) Paragraph 8 should refer to the two ways by which a secured creditor could take priority with respect to the residual value of an asset, namely by stating in the registered notice the maximum amount secured by the first-priority ranking security right or by a subordination agreement;

(f) Paragraph 9 should be reconsidered as it appeared to repeat points made in paragraphs 6-8;

(g) Paragraph 10 should be completed;

(h) Paragraph 11 should be deleted;

(i) Paragraphs 15-18 appeared to address third-party effectiveness issues and should be limited to priority issues;

(j) Paragraph 17, the second part of the second sentence should be deleted;

(k) Paragraphs 21-22 and 24-25 should be limited to issues of priority and avoid addressing third-party effectiveness issues;

(l) Paragraph 23 should clarify that the concept of “control” did not flow from the concept of “possession” and should focus on the rule that control gave a superior priority right;

(m) Paragraphs 24 and 25 should be recast in a more objective way;

(n) Paragraphs 26-33 should refer back to the chapter on creation with respect to the creation of a security right in future advances and clarify that priority extended to future advances as of the time the security right became effective against third parties;

(o) Paragraph 31 should be recast to clarify that it addressed an issue that was distinct from the issue of priority in future advances and to refer to a statement of the maximum amount and subordination;

(p) In paragraph 75, in the phrase “the lease is entered into”, the word “lease” should be replaced with the word “licence”;

(q) In paragraph 110, the last sentence should be deleted, to reflect the fact that there was no obligation to disclose the existence of a control agreement, by contrast with the publicity regime inherent in the operation of a specialized registry;

(r) In paragraph 112, the word “present” should be inserted before the phrase “right of set-off”, and the words “unless it has disapplied such right” should be inserted after the words “non-secured transactions law”; and the last sentence should be deleted.

2. Chapter VIII. Rights and obligations of the parties**(a) Recommendations (A/CN.9/631, recommendations 108-113)**

28. The Committee adopted recommendations 108-113.

(b) Commentary (A/CN.9/631/Add.5)

29. The Committee approved the substance of the commentary to chapter VIII.

3. Chapter IX. Rights and obligations of third-party obligors**(a) Recommendations (A/CN.9/631, recommendations 114-127)**

30. The Committee adopted recommendations 114-127.

(b) Commentary (A/CN.9/631/Add.6)

31. The Committee approved the substance of the commentary to chapter IX, subject to the addition in paragraph 22 of a reference to another approach, under which depositary banks were treated in the same way as debtors of receivables and their consent was not required for a security right to be created in a right to payment of funds credited to a bank account.

4. Chapter X. Post-default rights**(a) Recommendations (A/CN.9/631, recommendations 128-172)**

32. With respect to recommendation 128, some doubt was expressed as to whether reference should be made to commercially reasonable standards of conduct. It was stated that reference to good faith was sufficient. It was also observed that commercially reasonable standards were not universally understood in the same way. In response, it was noted that the draft Guide was designed to strike a balance between the need to allow the secured creditor some flexibility in the enforcement of its rights and the need to protect the rights of the grantor and its other creditors. It was also stated that that standard of conduct would require, for example, a secured creditor to obtain possession of the encumbered assets in a way that would be acceptable under local market conditions and to sell the assets in the relevant market with a view to obtaining the best possible price. In that connection, it was pointed out that the standard did not focus on the result (for example, that the creditor should obtain the best price) but on the enforcement procedure (for example, best price reasonably obtainable). It was agreed that the commentary should explain the term “commercially reasonable standards” giving examples.

33. With respect to recommendation 132, it was agreed that the phrase “does not affect” should be replaced with the phrase “may not adversely affect”, since only an adverse effect would be objectionable.

34. With respect to recommendation 141, it was agreed that the last sentence should be removed from the recommendation and included in the commentary to the chapter.

35. With respect to the reference in recommendations 147, subparagraph (a), 149 and 150 to “receiving” or “sending” a notice, differing views were expressed. One view was that, in order to effectively protect the interests of the grantor and its other creditors, receipt of the notice should be required. Another view was that the matter

should be left to other law, since it was well developed and should not be interfered with. However, the prevailing view was that it would be sufficient to require that the secured creditor should give notice to the grantor and its other creditors. It was stated that requiring receipt of the notice could create uncertainty, as there were different theories as to what constituted receipt (for instance, entry into a mailbox versus actual reading of the notice). In addition, it was observed that requiring that notice be received would increase the evidentiary burden of the secured creditor and thus have an adverse impact on the cost of credit. Moreover, it was said that leaving the matter to other law could result in failing to address sufficiently the potential impact of notice requirements on the cost of credit. It was also pointed out that the requirement that the secured creditor act in good faith and in a commercially reasonable manner, in conjunction with the general requirements regarding notice set out in recommendation 146, were sufficient to protect the interests of the grantor and its other creditors.

36. The Committee agreed that reference should be made in recommendations 147, subparagraph (a), 149 and 150 to the notice being “given to” the grantor and its other creditors. It was further agreed that the commentary (A/CN.9/631/Add.7, paras. 30-32) should address that matter in greater detail.

37. With respect to recommendation 150, it was agreed that the square brackets around the last sentence should be deleted, so that the recommendation would require the positive consent of the grantor to any proposal of the secured creditor to accept an encumbered asset in partial satisfaction of the grantor’s obligation. It was widely felt that, unlike the situation where the secured obligation was fully paid and the grantor was fully discharged, in situations where the secured obligation was only partially discharged, positive consent of the grantor should be required so that the grantor would have actual knowledge of the extent of the unsatisfied portion of the obligation, for which the grantor would remain liable.

38. With respect to recommendation 154, it was observed that it did not fit under the heading “Distribution of proceeds of extrajudicial disposition of an encumbered asset” as it referred to distribution of profits realized by a judicial disposition. It was agreed that either the heading should be changed or recommendation 154 should be placed elsewhere in the text.

39. With respect to recommendation 169, some doubt was expressed as to whether the consent of the depositary bank should be required for out-of-court enforcement by a secured creditor that had no control with respect to a right to payment of funds credited to a bank account. In response, it was explained that the reason for that approach was that the bank-client relationship should not be interfered with. It was also stated that, unlike debtors of trade receivables, depositary banks were involved in different kinds of practices subject to regulatory law that justified different treatment.

40. Subject to the above-mentioned changes and consequential amendments to the commentary to the chapter, the Committee adopted recommendations 128-172.

(b) Commentary (A/CN.9/631/Add.7)

41. The Committee approved the substance of the commentary to chapter X subject to the changes referred to above and to the following changes:

(a) In paragraphs 38-39, it should be explained that the right of the grantor to cure the default and reinstate the secured obligation was a matter for the agreement of the parties and the law of obligations;

(b) In paragraphs 57-58, it should be clarified that the right of the secured creditor to take over the management of the grantor's business and to sell it as a going concern could raise difficult issues, including the liability of the secured creditor for management acts and the protection of rights of other creditors;

(c) In paragraph 92, it should be clarified that, if the proceeds took the form of a type of asset, such as receivables, with respect to which special enforcement rules applied, enforcement should follow the rules applicable to that type of asset.

5. Chapter XI. Insolvency

(a) Definitions and recommendations (A/CN.9/631, recommendations 173-183)

42. The Committee noted that the definitions and the recommendations contained in part A of chapter XI of the draft Guide were taken from the UNCITRAL Legislative Guide on Insolvency Law,³ while the recommendations in part B of that chapter expressed specific principles relating to security rights in a manner that was consistent with the Insolvency Guide. General support was expressed for that approach.

43. It was also noted that the presentation of the insolvency chapter differed from the presentation of other chapters of the draft Guide in order to accommodate selected recommendations and material from the commentary of the Insolvency Guide. In addition, it was noted that those recommendations and explanatory material were included to ensure that readers and users of the draft Guide were provided with sufficient background information to understand the intersection of secured transactions law and insolvency law, and to ensure consistency between the two guides.

44. In order to facilitate a clearer understanding of the relationship between the commentary and the two sets of recommendations, it was suggested that the recommendations in part A and part B should be presented with separate commentary. In response, it was noted that that presentation might inadvertently give the wrong impression that the matters addressed in the recommendations in part B had not been discussed in the Insolvency Guide, and might result in duplication and inconsistencies. It was also suggested that the insolvency chapter should be placed at the end of the draft Guide on the basis that it addressed what should be included in the insolvency law, rather than in the secured transactions law. There was sufficient support for that suggestion.

45. With respect to the definition of the term "financial contract" taken from the Insolvency Guide, it was stated that it might need to be reviewed depending on the decision of the Committee on the treatment of financial contracts in the draft Guide. In response, it was noted that the definition was based on article 5, subparagraph (k), of the United Nations Convention on the Assignment of Receivables in International Trade (2001).⁴ It was also noted that, if the Committee agreed on a different definition for the purpose of the draft Guide, the interrelationship between the two definitions would need to be explained, but the

³ United Nations publication, Sales No. E.05.V.10.

⁴ General Assembly resolution 56/81, annex.

definition of the Insolvency Guide could not be changed (see paras. 137-142 below).

46. Other proposals for clarification included: adding recommendation 63 from the Insolvency Guide, which would serve as additional background to the recommendations on post-commencement finance; and, if necessary in order to clarify the commentary, including additional recommendations from the Insolvency Guide. There was sufficient support for those suggestions.

47. With respect to recommendation 174 (non-unitary approach), it was agreed that it should be revised to reflect the decision of the Committee to refer to “retention-of-title right” and “financial lease right” in the context of the non-unitary approach to acquisition financing (see paras. 69-75 below).

48. With respect to recommendation 181, it was agreed that it should be revised to clarify that a subordination agreement would only be binding in insolvency to the extent that it was effective under law other than insolvency law.

49. Subject to the above-mentioned changes, the Committee confirmed the appropriateness of the presentation of the definitions and recommendations and adopted recommendations 173-183.

(b) Commentary (A/CN.9/631/Add.8)

50. Noting that the commentary to chapter XI was consistent with the Insolvency Guide, the Committee approved the substance of the commentary subject to the following changes:

(a) The discussion in the commentary should refer more clearly to the relevant recommendations and discuss additional recommendations of the Insolvency Guide;

(b) The origin of material from the Insolvency Guide should be clearly explained for the reader;

(c) The discussion of applicable law should be further developed and placed at the end of the commentary.

6. Chapter XII. Acquisition financing rights

(a) Recommendations (A/CN.9/631, recommendations 184-201)

51. The concern was expressed that requiring a notice in the general security rights registry for a retention-of-title sale or financial lease to be effective against third parties might inappropriately interfere with useful practices and undermine the notion of “ownership”. It was stated that recharacterization of ownership as a security device could create significant problems not only in retention-of-title sales and financial leases but also in repurchase transactions and other financial contracts. It was also observed that the notion of “grantor” was not appropriate in a retention-of-title sale or financial lease, and, in any case, registration of ownership should not be required. Furthermore, it was mentioned that lack of flexibility might undermine the acceptability of the draft Guide, as flexibility would be one important criterion in determining the value of the draft Guide. It was emphasized that there were significant concerns that needed to be addressed for consensus on that matter to be reached. In order to address those concerns, it was suggested that retention-of-title

sales and financial leases should not be recharacterized as security devices or be made subject to registration of a notice in the general security rights registry.

52. That suggestion was objected to. It was stated that the draft Guide did not recharacterize retention-of-title sales or financial leases. It was simply drawing the consequences from the fact that ownership in a retention-of-title sale or financial lease was diminished to the extent of the value of the amount of the purchase price or rent outstanding. It was also stated that retention-of-title related to tangible property other than negotiable instruments and negotiable documents and was not relevant to securities and financial contracts, which still remained to be discussed. It was also said that what was registered was a notice about a transaction that functioned as a warning to third parties that the person in possession of the assets might not be the owner. Furthermore, it was pointed out that, as the work of many international organizations and international financial institutions indicated, a modern law on secured transactions could not achieve its objective of increasing access to secured credit, which was a matter of high priority in particular for developing countries and countries with economies in transition, if it were not comprehensive in coverage and did not provide for registration of all transactions that performed security functions. It was also emphasized that the draft Guide was not a binding treaty or model law and it was up to States to enact or reject its recommendations in whole or in part. The Committee, recalling that the Commission, at its thirty-ninth session, had adopted the substance of the recommendations, including on acquisition financing devices,⁵ noted the policy decisions of the Commission with respect to the chapter on acquisition financing rights.

(i) *Section A. Unitary approach to acquisition financing rights*

53. With respect to recommendation 192 (unitary approach), the concern was expressed that the different treatment of inventory (for instance, the fact that no grace period was provided and notification of inventory financiers on record was required) could undermine inventory financing. In order to address that concern, it was suggested that recommendation 189 should apply to inventory as well.

54. That suggestion was objected to. It was observed that paragraphs 114-118 of the commentary to chapter XII (A/CN.9/631/Add.9) sufficiently explained the need for a different treatment of acquisition security rights in inventory.

55. With respect to recommendation 199 (unitary approach), the suggestion was made that, for the same reasons for which the super-priority for security rights in inventory did not extend to receivables, it should not extend to other payment rights, such as negotiable instruments, rights to the payment of funds credited to a bank account and rights to payment under independent undertakings. That suggestion received sufficient support. The Committee decided that the text in square brackets in recommendation 199 should be retained without the square brackets.

56. Subject to the above-mentioned changes, the Committee adopted recommendations 184-201 in section A (unitary approach) of chapter XII of the draft Guide.

⁵ *Official Records of the General Assembly, Sixty-first Session, Supplement No. 17 (A/61/17)*, paras. 63-70.

(ii) *Section B. Non-unitary approach to acquisition financing rights*

57. With respect to recommendation 191 (non-unitary approach), the concern was expressed that, to the extent that it referred to the notion of priority, which was not appropriate for ownership devices, it did not really constitute an alternative approach and was thus not useful.

58. In order to address that concern, the suggestion was made that recommendation 191 and other recommendations in section B (non-unitary approach) of chapter XII of the draft Guide should be revised to refer to terminology that would be compatible with ownership devices. There was sufficient support for that suggestion. The Committee agreed that the recommendations in section B should be reformulated with that objective in mind. It was also agreed that recommendation 191 (non-unitary approach) should be revised to provide that a lender could obtain an acquisition security right directly from the grantor or an acquisition financing right through an assignment of the secured obligation from the supplier (see paras. 77-79 and 89 below).

59. With respect to recommendation 192 (non-unitary approach), a number of concerns were expressed. One concern was that it might not be easy to determine whether recommendation 189 or recommendation 192 should apply, as inventory in the hands of the seller could be equipment in the hands of the buyer, and the draft Guide did not make it clear in whose hands the assets had to constitute inventory. Another concern was that third-party financiers would have no way of ascertaining whether inventory or tangible property other than inventory was involved in a particular transaction. Yet another concern was that the requirement for registration of a notice in the general security rights registry and notification of inventory financiers on record before delivery of the goods could delay and complicate transactions, in particular cross-border transactions, involving different registries and languages. Yet another concern was that the requirements of registration and notification resulted in favouring the general inventory financier over the supplier of goods on credit. In order to address those concerns, the suggestion was made that recommendations 189 and 192 should be merged so that one rule along the lines of recommendation 189 would apply to the priority of security rights in both inventory and tangible property other than inventory.

60. That suggestion was objected to. It was stated that the term “inventory” was widely used in most legal systems and was defined and referred to in the draft Guide in several recommendations. It was also observed that whether tangible property constituted inventory depended on whether it was held as inventory by the grantor (for example, the buyer in an acquisition financing transaction). In addition, it was said that a modern registry system and the use of one registration and one notice covering one or more acquisition financing transactions between the same parties over a long period of time (for instance, five years; see recommendation 196) would not create costs or delays to trade. Moreover, it was pointed out that the difficulty of cross-border transactions was not a problem that arose only in the context of acquisition financing transactions. It was also said that recommendation 192 achieved a balance among the various interests in that a supplier’s right would be given priority subject to normal due diligence (including on whether the goods constituted inventory), an inventory financier’s right would be sufficiently protected through the requirements for registration and notification and the buyer would benefit from competitive credit terms. Finally, it was mentioned that the regime contemplated by the draft Guide would be an improvement over the current situation in many legal systems, in which retention of title was lost if the assets

concerned were exported to or through a State that did not recognize retention of title. Under the draft Guide, instead of losing its security entirely, the retention-of-title supplier would in such circumstances retain a security right.

61. In response, it was stated that a more flexible approach should be taken, as the conditions for trade and financing would not be the same in all countries. It was also observed that such flexibility was inherent in a guide that, by definition, was designed to provide non-binding guidance to States. Therefore, the suggestion was made that two alternatives should be presented on that matter, one treating differently inventory and tangible property other than inventory (along the lines set out in recommendations 189 and 192) and another treating both in the same way (along the lines set out in recommendation 189).

62. Diverging views were expressed as to the economic consequences of such an approach. One view was that it would have a negative impact on inventory financing, which might in turn result in a general contraction of credit. Another view was that the usefulness of the draft Guide might be diminished if it offered alternatives on important issues such as the issue of priority. Yet another view was that that approach struck an appropriate balance among all interests concerned and should be adopted.

63. The Committee agreed that, in order to ensure the flexibility of the draft Guide to meet the needs of States with differing needs, an alternative approach to recommendations 189 and 192 should be offered in both sections A and B of chapter XII (the unitary and the non-unitary approaches). Under this alternative approach, a new recommendation along the lines of recommendation 189 would address the priority position applicable to an acquisition security right or an acquisition financing right in tangible property. It was also agreed that the commentary should draw the attention of legislators to the economic and other consequences of each option (see paras. 88-90 below).

64. With respect to recommendation 194, it was suggested that it might be usefully clarified, as it seemed to refer to a judgement obtained after a security right was created but before it was made effective against third parties (see para. 92 below).

65. With respect to recommendations 198 and 199, it was agreed that their formulation should be adjusted to fit the alternative approach to recommendations 189 and 192 without, however, changing their underlying policy. Accordingly, the priority provided in the new recommendation should extend to proceeds of tangible property other than inventory (for example, equipment), as well as to proceeds of inventory except proceeds in the form of receivables or other payment rights.

66. It was widely felt that an extension of the priority given to an acquisition financing right to such proceeds of inventory could have an adverse impact on receivables financing. It was also generally considered that such a result would mean an unnecessary departure from current law in most States, under which such priority was limited to the assets subject to the acquisition financing right and did not extend to their proceeds. It was also observed that, in the few jurisdictions in which such priority extended to proceeds of inventory, priority was lost if the assets were commingled with other assets of the same type and lost their separate identity (see para. 98 below).

67. Recalling its decision that the recommendations in section B (non-unitary approach) of chapter XII of the draft Guide should use terminology based on the

notion of “ownership” (see para. 58 above), the Committee considered a proposal with respect to certain definitions and the recommendations dealing with the non-unitary approach to acquisition financing. It was stated that the proposed revisions were intended to: deploy terminology relating to ownership rather than security rights, which was the essence of the non-unitary approach; track the order and the structure of the recommendations of the unitary approach; implement the principle of the functional equivalence of security rights and uses of ownership for security purposes; and implement the principle of equal treatment of all acquisition financing providers. It was noted that, as a result of those two principles, not only sellers and financial lessors but also lenders could obtain an acquisition financing right that enjoyed super-priority (in other words, priority as of the time of the delivery of tangible property other than inventory, provided that a notice was registered in the general security rights registry within the applicable grace period). It was also noted that, if sellers or financial lessors failed to register a notice in the general security rights registry within the relevant grace period, they would obtain a normal security right to which the general priority rules would apply (that is to say, priority of a security right in tangible property other than inventory would be achieved as of the time of registration of a notice with respect to the security right, which would be after the expiry of the grace period).

68. While it was widely felt that the proposal formed a good basis for discussion, it was stated that no final decision could be made. In that connection, it was observed that the proposal constituted a reformulation of recommendations the substance of which (in other words, the underlying policies) had already been approved by the Commission at its thirty-ninth session⁶ and by Working Group VI (Security Interests) at its twelfth session (A/CN.9/620, paras. 84-90). It was also said that, for the Commission to be able to adopt the draft Guide at the resumed fortieth session, it was essential to finalize considerations with respect to the matters covered during the first part of the session. The Committee, therefore, agreed to proceed with its consideration of the proposal with a view to adopting the relevant definitions and recommendations.

69. With respect to the definitions, it was suggested that the draft Guide should use the terms “retention-of-title right” and “financial lessor’s right” rather than the term “acquisition financing right” (A/CN.9/631/Add.1, para. 19). It was widely felt that use of those terms would be more consistent with terminology relating to ownership devices.

70. With respect to the term “retention-of-title right”, the following text was proposed:

“‘Retention-of-title right’, a term used only in the context of a non-unitary approach, means a seller’s right in tangible property, other than negotiable instruments or negotiable documents, pursuant to an agreement with the buyer by which ownership of the tangible property that is the object of the sale is not transferred from the seller to the buyer until the purchase price is paid, and includes any arrangement by which a creditor that has provided credit to enable a person to acquire possession or use of tangible property, other than negotiable instruments or negotiable documents, reserves the right to become the irrevocable owner of the tangible property in satisfaction of the repayment obligation.”

⁶ Ibid.

71. It was noted that the first part of the proposed text was based on the definition of the term “retention-of-title right”, while the second part (“and includes ... repayment obligation”) was based on part (iv) of the definition of the term “acquisition financing right” (A/CN.9/631/Add.1, para. 19). It was also noted that the second part was intended to address situations in which a seller transferred ownership to a buyer but retained the right to recover ownership if the purchase price was not paid in full within the time period agreed upon. However, it was stated that the second part could be read as also referring to a lender being able to retain ownership in goods, the acquisition of which the lender had financed. It was also observed that such an understanding of the term “retention-of-title right” would be inconsistent with the meaning given to that term in most jurisdictions. In addition, it was said that it was not necessary to complicate the notion of “retention-of-title right”, as long as the recommendations made it clear that a lender could obtain a retention-of-title or financial lease right. It was widely felt that that result was necessary to ensure the economic equivalence of ownership and security devices and to treat equally all acquisition financing providers.

72. Subject to consideration in the context of recommendation 184 (see paras. 77-79 below) of the issue of whether a lender could obtain a retention-of-title or financial lease right, the Committee agreed that the second part of the definition could be deleted. It was also agreed that words along the lines “or irrevocably transferred” might be added to the first part of the definition.

73. With respect to the definition of the term “financial lessor’s right”, the following text was proposed:

“‘Financial lessor’s right’, a term used only in the context of the non-unitary approach, means a lessor’s right in tangible property, other than negotiable instruments or negotiable documents, that is the object of a lease agreement under which, at the end of the term of the lease:

“(i) The lessee automatically becomes the owner of the tangible property that is the object of the lease;

“(ii) The lessee may acquire ownership by paying no more than a nominal price; or

“(iii) The tangible property has no more than a nominal residual value.

“The term includes a hire-purchase agreement.”

74. The Committee noted that the proposed text was based on the definition of the term “financial lease” (A/CN.9/631/Add.1, para. 19), and agreed that, for the sake of consistency with the term “retention-of-title right”, it should be revised to refer to “financial lease right”.

75. The Committee adopted the above-mentioned definitions, subject to minor editorial changes made by the Drafting Group. It was agreed that the meaning of the definitions should be explained in the commentary.

76. The Committee adopted the “Purpose” subsection of the recommendations in section B (non-unitary approach) of chapter XII of the draft Guide.

77. The Committee considered the following proposal for a new recommendation 184:

“Alternative methods of acquisition financing

“184. The law should provide for a regime of acquisition security rights identical to that adopted in the unitary system. All creditors, both suppliers and lenders, may acquire an acquisition security right in conformity with that regime. In addition, the law should provide for a regime of acquisition financing based on retention-of-title sales and financial leases. The law should further provide that a lender may acquire the benefit of a retention-of-title right and a financial lessor’s right through an assignment of the obligations owing to the seller or lessor.”

78. It was agreed that the first three sentences were sufficient in reflecting the principle of functional equivalence of retention-of-title sales (and financial leases) with secured transactions and the principle of equal treatment of all acquisition financing providers. However, with respect to the last sentence, the concern was expressed that, if a lender could obtain a retention-of-title right or a financial lease right only by way of an assignment of the obligation owed to the seller or the financial lessor, the consent of the seller or the financial lessor would be required. It was explained that, as a result, the lender would have to give value in return, a result that could eliminate any benefits that buyers or lessees could obtain as a result of the competition of acquisition financing providers. In order to address that concern, it was suggested that reference should be made in recommendation 184 to the possibility of a lender acquiring a retention-of-title or financial lease right by paying the seller or financial lessor and being subrogated in the latter’s rights towards the buyer or lessee. There was sufficient support for that suggestion.

79. Subject to the addition at the end of words along the lines “or subrogation”, the Committee adopted the proposed new recommendation 184. It was also agreed that a summary explanation of subrogation and the manner in which retention-of-title or financial lease rights could be acquired by lenders through subrogation would be included in the commentary.

80. The Committee considered the following proposal for a new recommendation 185:

“Equivalence of a retention-of-title and a financial lessor’s right to an acquisition security right

“185. The rules governing acquisition financing should produce functionally equivalent economic results regardless of whether the creditor’s right is a retention-of-title right, a financial lessor’s right or an acquisition security right.”

81. It was noted that the proposed text was based on the original text of recommendation 184 in document A/CN.9/631. The Committee adopted the proposed new recommendation 185.

82. The Committee considered the following proposal for a new recommendation 186:

“Evidentiary requirement for retention-of-title and financial lessor’s rights

“186. The law should provide that a retention-of-title right and a financial lessor’s right must be evidenced in writing before the buyer or lessee obtains possession of the tangible property that is the object of the right.”

83. It was noted that, unlike the original text of recommendation 185 in document A/CN.9/631, on which the proposed new recommendation 186 was based and which referred to “creation”, the proposed new recommendation referred to evidentiary requirements. It was explained that a retention-of-title sale established a kind of an expectancy of ownership on the part of the buyer, the value of which was equal to the amount of the paid portion of the purchase price, but did not “create” ownership as such. The Committee adopted the proposed new recommendation 186.

84. The Committee considered the following proposal for a new recommendation 187:

“Right of buyer or lessee to create a security right in residual value of sold or leased property

“187. The law should provide that a buyer or lessee may create a security right in tangible property that is the object of a retention-of-title right or a financial lessor’s right. The security right is enforceable only to the extent of the value remaining in the tangible property after the obligation owing to the seller or financial lessor is satisfied.”

85. It was noted that the first sentence of the proposed text was based on the original text of recommendation 185 bis in document A/CN.9/631. However, it was widely felt that the second sentence went beyond its intended meaning to limit the security right created by the buyer in the tangible assets to the paid portion of their purchase price. It was stated that the text was not intended to deal with enforcement but rather to set out a priority rule, according to which the retention-of-title seller or financial lessor would be paid ahead of a secured creditor that obtained a right in the goods from the buyer or lessee. It was agreed that the second sentence should be revised to read along the following lines: “The security right is limited to the value remaining in the tangible asset in excess of the obligation owing to the seller or financial lessor.” Subject to that change, the Committee adopted the proposed new recommendation 187.

86. The Committee considered the following proposal for a new recommendation 188:

“Effectiveness of a retention-of-title or financial lessor’s right in consumer goods against third parties

“188. The law should provide that a retention-of-title and a financial lessor’s right in consumer goods is effective against third parties upon conclusion of the sale or lease provided that the right is evidenced by a writing in accordance with recommendation 186.”

87. It was noted that the proposed text was based on the original text of recommendation 190 in document A/CN.9/631. It was also noted that: the substance of the original text of recommendation 186 was covered in the proposed new recommendations 188-190 (see para. 86 above as regards new recommendation 188 and para. 88 below as regards new recommendations 189-190); the original text of recommendations 187 and 193 was not necessary as a retention-of-title or financial lease right in consumer goods would normally not be subject to registration in a title registry; the original text of recommendation 188 was not necessary, as the issue addressed therein would normally be framed as one of effectiveness against third parties rather than priority. The Committee adopted the proposed new recommendation 188.

88. The Committee considered the following proposal for new recommendations 189 and 190 (alternative A) and a new recommendation 189 (alternative B):

“Alternative A

“Effectiveness of a retention-of-title or financial lessor’s right in tangible property other than inventory or consumer goods against third parties

“189. The law should provide that a retention-of-title or financial lessor’s right in tangible property other than inventory or consumer goods is effective against third parties only if:

“(a) The seller or lessor retains possession of the tangible property that is the object of the sale or lease; or

“(b) A notice relating to the right is registered not later than [specify a short time period, such as 20 or 30 days] days after delivery of possession of the tangible property to the buyer or lessee.

“Effectiveness of a retention-of-title or financial lessor’s right in inventory against third parties

“190. The law should provide that a retention-of-title or financial lessor’s right in inventory is effective against third parties only if:

“(a) The seller or lessor retains possession of the inventory; or

“(b) Before delivery of the inventory to the buyer or lessee:

“(i) A notice relating to the right is registered in the general security rights registry; and

“(ii) A secured creditor with an earlier registered non-acquisition security right created by the buyer or lessee in tangible property of the same kind as the inventory is notified in writing that the seller or lessor intends to claim a retention-of-title or financial lessor’s right. The notification should describe the inventory sufficiently to enable the secured creditor to determine the nature of the inventory subject to the retention-of-title or financial lessor’s right.

“Alternative B

“Effectiveness of a retention-of-title or financial lessor’s right in tangible property other than consumer goods against third parties

“189. The law should provide that a retention-of-title or financial lessor’s right in tangible property other than consumer goods is effective against third parties only if:

“(a) The seller or lessor retains possession of the tangible property; or

“(b) A notice relating to the right is registered not later than [specify a short time period, such as 20 or 30 days] days after delivery of the tangible property to the buyer or lessee.”

89. The Committee noted that alternative A was based on the original text of recommendations 189 and 192 in document A/CN.9/631, while alternative B implemented the agreement of the Committee that no distinction should be drawn between inventory and tangible property other than inventory (see para. 63 above). It was also noted that the original text of recommendation 190 in

document A/CN.9/631 was not necessary, since the matter was addressed in the proposed new recommendation 188, under which a retention-of-title sale of consumer goods was effective against third parties upon the conclusion of the sales contract. It was also noted that the original text of recommendation 191 in document A/CN.9/631 was not necessary, as its substance was addressed in the proposed new recommendation 184 (see paras. 77-79 above).

90. It was stated that reference should be made in both alternative A and alternative B to registration of a notice in the general security rights registry for both retention-of-title and financial lease rights so as to ensure that the registry would cover all the various rights in a comprehensive way, a result that would promote efficiency and transparency. The Committee adopted the proposed new recommendations 189 and 190 (alternative A) and the proposed new recommendation 189 (alternative B).

91. The Committee considered the following proposal for a new recommendation 191:

“Effectiveness of a retention-of-title or financial lessor’s right in an attachment to immovable property as against earlier competing rights registered in the immovable property

“191. The law should provide that a retention-of-title or financial lessor’s right in tangible property that is to become an attachment to immovable property is effective against existing rights in the immovable property that are registered in the immovable property registry (other than an existing right that secures a loan financing the construction of the immovable property) only if it is registered in the immovable property registry no later than [specify a short time period, such as 20-30 days] days after the tangible property becomes an attachment.”

92. It was noted that the substance of the original text of recommendation 193 in document A/CN.9/631 was covered in the proposed new recommendation 188, under which the retention-of-title seller or financial lessor did not need to register in any title registry. It was also noted that the original text of recommendation 194 in document A/CN.9/631 was no longer necessary, as the retention-of-title seller or financial lessor as an owner would always prevail over a judgement creditor of the buyer or lessor. In addition, it was noted that the proposed new recommendation 191 was an appropriate reformulation of the original text of recommendation 195. The Committee adopted the proposed new recommendation 191.

93. The Committee considered the following proposal for a new recommendation 192:

“One notification or notice sufficient

“192. The law should provide that a single notification to secured creditors with earlier registered non-acquisition security rights pursuant to recommendation 190 may cover retention-of-title and financial lessor’s rights under one or more than one retention-of-title sales or financial leases between the same parties without the need to specifically identify each transaction. However, the notification is effective only for rights in tangible property that is delivered into the possession of the buyer or lessee within a period of [specify time, such as five years] years after the notification is given.”

94. It was noted that the proposed text was based on the original text of recommendation 196 in document A/CN.9/631. It was agreed that, as notification of inventory financiers on record was required only in the context of alternative A in recommendation 190 (non-unitary approach), the new proposed recommendation 192 should follow the new proposed recommendation 190 in alternative A (see para. 88 above). It was also agreed that reference should be made to “notice” rather than to “notification” since, in some languages, the two terms had the same meaning, and the draft Guide used the term “notification” only with the qualifying words “of the assignment”. Subject to those changes, the Committee adopted the proposed new recommendation 192.

95. The Committee considered the following proposal for a new recommendation 193:

“One registration or notice sufficient

“193. The law should provide that registration of a single notice is sufficient to ensure the third-party effectiveness of retention-of-title and financial lessor’s rights under multiple transactions entered into between the same parties, whether concluded before or after the registration, to the extent they cover tangible property that falls within the description contained in the notice.”

96. It was noted that the proposed text was based on the original text of recommendation 197 in document A/CN.9/631. Subject to referring only to registration in the heading, the Committee adopted the proposed new recommendation 193.

97. The Committee considered the following proposal for new recommendations 194-197:

“Extension of a retention-of-title or financial lessor’s right in proceeds of tangible property other than inventory or consumer goods

“194. The law should provide that a retention-of-title or financial lessor’s right in tangible property other than inventory or consumer goods extends to the proceeds of such property (including proceeds of proceeds).”

“Third-party effectiveness of a retention-of-title or financial lessor’s right in proceeds of tangible property other than inventory or consumer goods

“195. The law should provide that a retention-of-title or a financial lessor’s right in proceeds is effective against third parties only if the proceeds are described in a generic way in the registered notice by which the seller’s or lessor’s rights were made effective against third parties or the proceeds consist of money, receivables, negotiable instruments or rights to payment of funds credited to a bank account.

“196. If recommendation 195 does not apply, the right in the proceeds is effective against third parties for [to be specified] days after the proceeds arise and continuously thereafter, provided a notice of the right in the proceeds is registered in the general security rights registry before the expiry of that period.

“Extension of a retention-of-title or financial lessor’s right in proceeds of inventory

“197. The law should provide that a retention-of-title or financial lessor’s right in inventory extends to its proceeds, other than proceeds in the form of receivables, negotiable instruments, funds credited in a bank account and the obligation to pay under an independent undertaking (including proceeds of proceeds), provided that the seller or lessor notifies earlier-registered secured creditors with security rights in tangible property of the same kind as the proceeds before the proceeds arise.”

98. It was noted that the proposed new recommendations 194 and 197 were based on the original text of recommendations 198 and 199 in document A/CN.9/631, while the proposed new recommendations 195 and 196 were based on the original text of recommendations 40 and 41 in document A/CN.9/631.

99. It was stated that the proposed new recommendations 194 and 197 should be aligned with the approach taken in most jurisdictions in which retention-of-title and financial lease rights were known as devices separate from secured transactions; they did not extend to proceeds; and no distinction was drawn between proceeds of inventory and tangible property other than inventory. In response, it was observed that a solution that would avoid inconsistency with the regime applicable to ownership devices would be to provide that a retention-of-title or financial lease right would not extend to proceeds and that the retention-of-title seller or financial lessor would have instead a normal security right in proceeds, to which the general third-party effectiveness and priority rules would apply (pursuant to recommendations 40, 41 and 80). In addition, it was said that, in order to ensure the same results in the unitary and the non-unitary approach, that security right should have super-priority in proceeds in the form of equipment but not in proceeds of inventory in the form of the payment rights described in the proposed new recommendation 197.

100. Subject to those changes, the Committee expressed initial approval for the substance of the proposed new recommendations 194 and 197 but agreed to recommend to the Commission that a revised text of the recommendations should be reviewed at the resumed fortieth session of the Commission.

101. The Committee considered the following proposal for new recommendation 198:

“Effect of failure to obtain third-party effectiveness of a retention-of-title or financial lessor’s right

“198. The law should provide that if a seller or lessor fails to comply with the requirements for obtaining third-party effectiveness of a retention-of-title or financial lessor’s right, the seller or lessor has a security right in the tangible property subject to the sale or lease, and the general regime for security rights applies.”

102. The suggestion was made that the proposed new text should be revised to make it clear that, if a retention-of-title seller or a financial lessor failed to register a notice in the general security rights registry within the applicable grace period, such a seller or lessor would retain a security right as against third parties (provided that they registered a notice), but ownership would pass to the buyer. In connection with that suggestion, the concern was expressed that, at least between the seller and the buyer (or the lessor and the lessee), ownership could not pass before full payment of

the price. In order to address that concern, the suggestion was made that the proposed text should be revised to provide that ownership would pass to the buyer or lessee “as against third parties” and the seller or lessor would have a security right, provided that it registered a notice in the general security rights registry after the expiry of the grace period. That suggestion received sufficient support. Subject to that change, the Committee adopted the proposed new recommendation 198. It was also agreed that the new recommendation (as for all new or revised recommendations) should be explained in the commentary.

103. The Committee considered the following proposal for new recommendations 199-201:

“Post-default enforcement of retention-of-title and financial lessor’s rights

“199. The law should provide a regime for the post-default enforcement of retention-of-title and financial lessor’s rights that deals with:

“(a) The manner in which the seller or lessor may obtain possession of the tangible property subject to the sale or lease;

“(b) Whether the seller or lessor is required to dispose of the tangible property and, if so, how;

“(c) Whether the seller or lessor may retain any surplus; and

“(d) Whether the seller or lessor has a claim for any deficiency against the buyer or lessee.

“200. The law should provide that the regime that applies to the post-default enforcement of a security right applies to the post-default enforcement of a retention-of-title or financial lessor’s right except to the extent necessary to preserve the coherence of the regime applicable to sale and lease.

“Law applicable to retention-of-title and financial lessor’s rights

“201. The law should provide that the provisions of this law on private international law apply to retention-of-title and financial lessor’s rights.”

104. It was noted that the proposed text was based on the original text of recommendations 200 and 201 in document A/CN.9/631. Subject to referring to a “financial lease right” rather than to a “financial lessor’s right” (see para. 74 above), the Committee adopted the proposed new recommendations 199-201.

105. Subject to the above-mentioned changes and consequential amendments to the commentary to the chapter, the Committee adopted recommendations 184-201 of section B (non-unitary approach) of chapter XII of the draft Guide.

(b) Commentary (A/CN.9/631/Add.9)

106. Subject to any changes consequential upon the revisions to recommendations 184-201 (unitary and non-unitary approaches), the Committee approved the substance of the commentary to chapter XII.

7. Chapter XIII. Private international law

(a) Recommendations (A/CN.9/631, recommendations 202-222)

107. The view was expressed that the title of the chapter should be adjusted to fit its contents (in other words, the law applicable to security rights). It was widely felt

that the term “private international law” was broader than the terms “conflict of laws” or “applicable law”, since it included issues of jurisdiction, recognition and enforcement of foreign judgements. It was agreed that the title to the chapter should be changed to “conflicts of laws” or “applicable law” or any other title that may be suggested by United Nations terminology experts.

108. In response to a question with respect to the footnote to the chapter, it was noted that the footnote emphasized the contribution of the Permanent Bureau of the Hague Conference on Private International Law to the chapter. Expressing its appreciation for that contribution, the Committee agreed that reference should be made to the Permanent Bureau rather than to the Conference.

109. With respect to recommendation 202, it was agreed that the law of the State under which a specialized registration system was maintained should govern security rights in tangible property subject to a specialized registration system.

110. The suggestion was also made that, with respect to security rights in goods covered by a negotiable instrument, reference should be made to the law of the State in which the negotiable document was located. The Committee agreed to defer consideration of that suggestion to a later time in the session after it had had an opportunity to discuss the revised version of recommendation 107 (priority of a security right in a negotiable document or goods covered by a negotiable document) (see paras. 130-134 below). The suggestion was also made that the Committee should consider the law applicable to the transfer of a security right. In that connection, the view was expressed that the approach taken in the United Nations Assignment Convention should be followed. The Committee decided to postpone consideration of that suggestion until it had had an opportunity to consider all the recommendations in chapter XIII (see para. 127 below).

111. With respect to recommendation 204, a number of concerns were expressed. One concern was that, while the rule might be appropriate for assignments of future trade receivables or of trade receivables assigned in bulk, it would be inappropriate for receivables arising from financial contracts. Another concern was that the rule might be inappropriate even for trade receivables. In that connection, reference was made to the European Commission proposal for a regulation of the European Parliament and the Council on the law applicable to contractual obligations (the proposed Rome I regulation), in the context of which the law of the assignor’s location and the law governing the assigned receivable were discussed as the options for the law applicable to third-party effects of assignments. Yet another concern was that the rule in recommendation 204 would result in the application of two different laws in a situation where a person made an assignment in State X and then moved to State Y and made a second assignment of the same receivables. It was added that the same problem would arise in a situation where A in State X assigned to B in State Y and B assigned to C in State Z. Yet another concern was that it would be difficult for debtors of receivables to determine which law applied to their discharge or to ensure that they would not have to deal with an inconvenient or unacceptable creditor. In view of the above-mentioned concerns, support was expressed in favour of the law governing the receivable.

112. In response, it was stated that the issue of financial contracts still remained to be discussed (see paras. 137-142 below). As to trade receivables, it was observed that the draft Guide adopted the approach of the United Nations Assignment Convention. In that connection, the Committee recalled that the Commission at its thirty-ninth session, in 2006, “noted with appreciation that the European

Commission shared the concerns expressed in the note by the Secretariat (see A/CN.9/598/Add.2, para. 34) and admitted that the adoption in a European Union binding instrument of an approach to the law applicable to third-party effects of assignments that would be different from the approach taken in the United Nations Assignment Convention would undermine the certainty reached at the international level and might have a negative impact on the availability and the cost of credit. In addition, the Commission noted with appreciation that the European Commission had expressed its willingness to cooperate closely with the UNCITRAL secretariat to ensure, as far as possible, coherence between the two instruments and the facilitation of ratification of the United Nations Assignment Convention by European Union member States”.⁷

113. In addition, it was observed that, under recommendation 216, the governing law would be that of the State in which the grantor was located at the time a priority conflict arose, rather than two governing laws. It was also said that, under recommendation 46, an assignee in State X could preserve its third-party effectiveness and priority if it met the third-party effectiveness requirements in State Y within a certain period of time. It was further emphasized that, under the draft Guide, no issue of priority arose (to which recommendation 204 could apply) in a situation where two competing claimants took a right from different persons (as in an assignment from A to B and from B to C). Moreover, it was pointed out that, under recommendation 213, subparagraph (a), the debtor of a receivable could obtain a discharge if it paid in accordance with the law governing the receivable, without being concerned whether the person that received the payment was entitled to retain proceeds as against competing claimants. It was also mentioned that whether a receivable was assignable was, under recommendation 213, subparagraph (b), also a matter for the law governing the receivable. Finally, it was noted that, after six years of intergovernmental negotiations in UNCITRAL that had led to the preparation of the United Nations Assignment Convention and another six years of equally detailed negotiations that had led to the preparation of the draft Guide, it was clear that the law governing the receivable would inadvertently result in the application of several laws, in the typical case of a receivables financing transaction that involved the assignment of receivables in bulk, and in uncertainty as to the applicable law, in the equally typical case of a receivables financing transaction involving the assignment of future receivables.

114. The Committee agreed that recommendation 204 provided the appropriate law and recalled the decision taken by the Commission at its thirty-ninth session to approve the substance of the recommendations of the draft Guide, including recommendation 204.⁸ It was also agreed that the commentary to the chapter should fully discuss the policy reasons justifying the approach taken in recommendation 204. In addition, it was agreed that the concerns expressed with regard to the law applicable to financial contracts would be discussed at a later stage in the session.

115. In the discussion, it was noted that recommendation 204 was one of the recommendations that might not be appropriate for security rights in intellectual property and would need to be reviewed in the context of any possible future work by the Commission on security rights in intellectual property (see paras. 155-157 below and A/CN.9/632, paras. 81-86).

⁷ Ibid., para. 243.

⁸ Ibid., para. 74.

116. With respect to recommendation 205, it was agreed that reference should be made, in this recommendation and in other relevant recommendations, to the law under which a specialized registration system was organized, but only if registration in such a system had priority consequences (and not tax or other consequences unrelated to priority).

117. As to recommendation 206, it was agreed that, in view of the strongly held views in support of both alternatives A and B, both alternatives should be retained. It was also agreed that the commentary should fully reflect the policy reasons underlying each alternative.

118. With respect to recommendation 214, the concern was expressed that reference to the law of the State where enforcement took place would create uncertainty, because: the place of enforcement could not be predicted at the time of conclusion of a transaction; in cases where the encumbered assets included both tangible and intangible assets, such an approach could result in the application of more than one law; and enforcement could involve several acts in several places, including places other than the place of the location of the encumbered assets.

119. In order to address that concern, it was suggested that reference should be made — for the enforcement of security rights in both tangible and intangible assets — to the law governing priority. In support of that suggestion, it was observed that, under such an approach, the law applicable to the enforcement of a security right in a tangible asset would be the law of the location of the asset (except in the case of tangible assets subject to a specialized registration system; see the second sentence of recommendation 202). It was also said that the law applicable to the enforcement of a security right in an intangible asset would be the law of the location of the grantor (except in the case of certain payment rights; see recommendations 206-210). In response to a question, it was explained that that approach could apply even in States that did not use the term “priority”, since the term “priority”, interpreted broadly, would cover any situation in which there was a conflict between competing rights.

120. That suggestion was objected to. It was stated that the compromise reached in recommendation 214 after long and difficult negotiations was a better result. It was also observed that application of the rule in recommendation 214, subparagraph (a), would result in the application of the law of the State where enforcement takes place to both procedural and substantive matters, while the reference to the law of the location of the grantor was appropriate with respect to the enforcement of security rights in intangible property (except with respect to certain payment rights; see recommendations 206-210).

121. In response, it was observed that, in the case of extrajudicial enforcement, no procedural matters arose and thus the certainty apparently offered by the rule in recommendation 214, subparagraph (a), could be said to be illusory. It was also stated that recommendation 214, subparagraph (a), appeared to be based on the potentially wrong assumption that enforcement would always take place in the State in which the assets were located. In addition, it was said that priority was so closely linked to enforcement that the same law should apply to both priority and enforcement.

122. Accordingly, it was proposed that both alternatives could be preserved. However, that suggestion did not attract sufficient support. It was widely felt that the importance of certainty with respect to the law applicable to the enforcement of a security right outweighed the benefits of the flexibility to be provided by

alternative recommendations. It was agreed that the recommendation should contain only the current text of recommendation 214 and that other approaches should be discussed in the commentary.

123. With respect to recommendation 215, the suggestion was made that it should refer to the location of the branch of the grantor, which was most closely connected to the security agreement. Noting that recommendation 215 reflected appropriately the correct approach of the United Nations Assignment Convention (article 5, subparagraph (h)), the Committee recalled the decision of the Commission at its thirty-ninth session to adopt the substance of recommendation 215.⁹

124. With respect to recommendation 216, subparagraph (a), it was widely felt that it should refer to the creation of a security right as a matter of fact rather than of law. In order to reflect that understanding, it was suggested that reference should be made to “putative” or “purported” creation. There was sufficient support for that suggestion.

125. With respect to recommendation 218, subparagraph (c), it was agreed that it should be revised along the following lines: “The rules in subparagraphs (a) and (b) of this recommendation do not permit the application of the provisions of the law of the forum on third-party effectiveness or the priority of a security right as against the rights of competing claimants.” That formulation, it was said, would ensure that the forum could not use principles of public policy to apply its own substantive law rules on third-party effectiveness or priority. On the other hand, it was observed, the forum could set aside the creation rules of the applicable law and apply instead its own substantive law rules on the creation of a security right. As a result, the forum could refuse to recognize that a security right had been effectively created, if that was not permitted under the substantive law of the forum (for instance, a security right in wages).

126. With respect to recommendation 219, subparagraph (b), it was agreed that it should be deleted, as recommendation 220 addressed the same point.

127. Recalling its decision to consider the law applicable to the transfer of a security right once it had completed its discussion of the recommendations in chapter XIII (see para. 110 above), the Committee agreed that the commentary could discuss the effect of a transfer of a receivable on a right securing payment of the receivable and the law applicable thereto, describing approaches taken in various legal systems, without, however, making any recommendation, as that matter related to the law applicable to contractual obligations.

128. Subject to the above-mentioned changes and consequential amendments to the commentary to the chapter, the Committee adopted recommendations 202-222.

(b) Commentary (A/CN.9/631/Add.10)

129. The Committee approved the substance of the commentary to chapter XIII subject to the changes referred to above and the following changes:

(a) In paragraph 2, as making the determination of the internationality of a case a condition precedent to the application of conflict-of-laws rules could undermine their application, the third and fourth sentences should be deleted;

⁹ Ibid.

(b) References to courts and, to the extent possible, to the forum in chapter XIII should be replaced by references to “authorities” and to the State in which a case “was examined” respectively;

(c) In paragraph 14, the text should be reviewed to avoid any implication that all legal systems took an identical stance on the application of the law of the location of the asset to the creation of a security right as between the parties;

(d) In paragraphs 35-40, any limitations that the Committee might introduce to the scope of recommendation 204 with respect to financial contracts (see paras. 137-142 below) should be discussed;

(e) In paragraph 56, it should be clarified that recommendation 214 was not designed to apply to procedural enforcement matters and that, in some States, such matters could arise only in the context of judicial enforcement.

8. Priority of a security right in a negotiable document or goods covered by a negotiable document/law applicable to the priority of a security right in a negotiable document or goods covered by a negotiable document

130. Recalling its decision to defer discussion of recommendation 107 to a later time in the session (see para. 25 above), the Committee considered the following proposal for a revised version of recommendation 107:

“107. The law should provide that a security right in tangible property made effective against third parties by possession of a negotiable document has priority over a competing security right made effective against third parties by another method. This rule does not apply if (i) the tangible property is not inventory and (ii) the security right of the secured creditor not in possession of the negotiable document was made effective against third parties before the earlier of (x) the time that the tangible property became represented by the negotiable document, and (y) the time when an agreement was made between the grantor and a secured creditor in possession of the negotiable document providing for the tangible property to be represented by a negotiable document so long as the tangible property became so represented within [30] days from the date of the agreement.”

131. It was noted that, under the proposed reformulation, recommendation 107 would provide that a security right that was made effective against third parties through the transfer of possession of a negotiable document to the secured creditor would have priority over a security right that was made effective against third parties in any other way. It was widely felt that that text would better reflect the policy of preserving the negotiability of negotiable documents and reflecting relevant commercial practices.

132. It was also generally considered that, in order to properly address the relevant commercial practices, the rule should be made subject to an exception, with respect to which the general priority recommendations would apply (in other words, priority should be determined as of the time of registration). It was stated that the exception referred to a security right in tangible property other than inventory (for instance, equipment). It was observed that, unlike inventory, equipment was not normally expected to be represented by a negotiable document and be made subject to a security right in the negotiable document. Therefore, a security right in equipment should be protected in the sense that the general priority rules should apply. It was also observed that the exception involved a security right that was made effective

against third parties before title to the tangible property became represented by the negotiable document or before conclusion of the agreement between the grantor and the secured creditor providing that title in the tangible property were represented by a negotiable document. It was stated that that exception was justified by the fact that a person taking possession of a negotiable document should first check the registry and determine whether the assets covered by the document were subject to a security right.

133. The Committee adopted the proposed new recommendation 107.

134. The Committee recalled its decision to revert to the question of the law applicable to a priority conflict between a possessory security right in a negotiable document and a non-possessory security right in the tangible property covered by the document (see para. 110 above). The Committee agreed that such a priority conflict should be referred to the law of the State in which the negotiable document was located. It was widely felt that such an approach would be in line with applicable principles of negotiable document law.

9. Chapter XIV. Transition

(a) Recommendations (A/CN.9/631, recommendations 223-230)

135. The Committee adopted recommendations 223-230.

(b) Commentary (A/CN.9/631/Add.11)

136. The Committee approved the substance of the commentary to chapter XIV.

10. Financial contracts

137. The Committee engaged in a preliminary discussion with respect to the application of the draft Guide to contingent payment rights arising under or from financial contracts. At the outset, it was stated that the draft Guide applied to contingent payment rights arising under or from financial contracts as it applied to intangible assets in general. It was also observed that, if all types of securities were excluded from the scope of the draft Guide, the draft Guide would still apply to certain types of payment rights arising under or from financial contracts (for instance, foreign exchange contracts). In addition, it was said that those types of payment rights should either be excluded from the draft Guide or be made subject to certain asset-specific rules. Moreover, it was pointed out that such rules should deal with several issues, such as those mentioned below.

138. One such issue was the definition of the term “financial contract”. In that connection, it was pointed out that the definition contained in the United Nations Assignment Convention (article 5, subparagraph (k)) was a good starting point but would need to be updated so as to take into account recent developments in practice. Another issue was the law applicable to security rights in payment rights arising under or from financial contracts. It was observed that the law of the grantor’s location, provided in recommendation 204, would not be appropriate with respect to such payment rights. Yet another issue was the way in which a security right in a payment right arising from or under a financial contract could be made effective against third parties and whether third-party effectiveness achieved by control would result in that security right having a superior priority ranking. Yet another issue was that anti-assignment agreements contained in financial contracts should be respected, a result that would require an adjustment to the definition of the term

“receivable” and recommendation 25. Yet another issue was the recharacterization of the transfer of a financial contract as a secured transaction.

139. It was also noted that the above-mentioned considerations would apply even more if only some types of securities were excluded from the draft Guide (see paras. 145-147 below). In any case, it was stated, further work would be required in order to prepare asset-specific rules to fully reflect financial contract practice.

140. In response, it was observed that any exclusion from or inclusion in the draft Guide of payment rights arising under or from financial contracts should be based on the definition of the term “financial contract” contained in the United Nations Assignment Convention, as the definition was sufficiently flexible to accommodate new practices. It was also pointed out that the Convention excluded only payment rights arising under or from financial contracts governed by netting agreements (article 4, subparagraph 2 (b), and article 5, subparagraphs (k) and (l), of the Convention). In addition, it was pointed out that the suggestion that different rules should apply to security rights in payment rights from or under financial contracts was based on the potentially wrong assumption that existing law was sufficiently developed and worked well.

141. At the same time, it was emphasized that work on security rights in payment rights arising under or from financial contracts should be deferred to the future, since the relevant issues required significant additional work and, in any case, the draft Guide should not be made even more complex or delayed. It was widely felt that such a result could adversely affect the acceptability or the usefulness of the draft Guide. As to any future work in this area, it was mentioned that it could take the form of another asset-specific part of the draft Guide. As to the question of the provisional treatment of financial contracts in the draft Guide, the various approaches taken in recommendation 4 were mentioned.

142. The Committee decided to postpone a final decision on the treatment of financial contracts in the draft Guide until it had had an opportunity to consider the treatment of securities and coordination with the work of the International Institute for the Unification of Private Law (Unidroit) on the draft Unidroit Convention on Substantive Rules regarding Intermediated Securities (see paras. 145-151 below).

11. Chapter II. Scope of application and other general rules

(a) Security rights in intellectual property (A/CN.9/631, recommendation 4, subparagraph (b), and related commentary)

143. The Committee noted that recommendation 4, subparagraph (b), deferred to intellectual property law if any inconsistency arose between the draft Guide and intellectual property law. While support was expressed for the substance of the recommendation, the concern was expressed that the bracketed text, adding the condition that intellectual property law should address matters relating to security rights in intellectual property, could complicate the application of intellectual property law. In order to address that concern, the suggestion was made that the bracketed text should be deleted. There was sufficient support for that suggestion. Subject to that change, the Committee adopted recommendation 4, subparagraph (b).

144. With respect to the commentary on intellectual property issues, it was widely felt that the revisions to the commentary agreed upon by Working Group VI (Security Interests) at its twelfth session (A/CN.9/620, paras. 111-120) should be

included in the commentary. Subject to those changes, the Committee approved the substance of the commentary on intellectual property issues.

(b) Securities (A/CN.9/631, recommendation 4, subparagraph (c))

145. With respect to recommendation 4, subparagraph (c), the Committee considered the question of whether the draft Guide should exclude all types of securities or intermediated securities only. The concern was expressed that an exclusion of intermediated securities only could result in overlap and conflict with the draft Unidroit Convention on Substantive Rules regarding Intermediated Securities and other regional and national texts. It was stated that a distinction between intermediated and non-intermediated securities was not easy to draw. It was also observed that, in some cases, the term “intermediated securities” might cover directly held securities in the so-called transparent holding systems, in which central securities depositories held securities for investors. In addition, it was said that securities raised different issues and should be subject to specific rules, the preparation of which would require careful study and discussion.

146. In that connection, it was suggested that possible future work of UNCITRAL in the area of securities should focus on directly held and non-traded securities, which were often the main asset that many small and medium-sized companies could offer as security for credit. On the other hand, it was also suggested that possible future work should: avoid drawing unnecessary distinctions between tradable and non-tradable securities and thus creating too many regimes; preserve title transfers; ensure that control was available as a method of third-party effectiveness and provided a security right with superior priority; and provide appropriate applicable law provisions. In addition, it was suggested that the rules on intermediated and non-intermediated securities should be integrated, as the distinction was not obvious. It was also suggested that title transfers and security rights in receivables arising from securities should be subject to the same regime.

147. It was agreed that all types of securities should be excluded from the draft Guide. Subject to that change, the Committee adopted recommendation 4, subparagraph (c). The Committee recommended to the Commission that future work should be undertaken with a view to preparing an annex to the draft Guide on certain types of securities, taking into account work by other organizations, in particular Unidroit.

(c) Financial contracts

148. Pursuant to its earlier decision to postpone a final decision on the treatment of payment rights arising under or from financial contracts in the draft Guide until it had had an opportunity to consider the treatment of securities and coordination with the work of Unidroit on the draft Unidroit Convention on Substantive Rules regarding Intermediated Securities (see para. 142 above), the Committee continued its discussion of whether security rights in payment rights arising under or from financial contracts and other similar contracts should also be excluded from the draft Guide. It was agreed that payment rights arising under or from financial contracts and foreign exchange contracts should be excluded. It was widely felt that security rights in such payment rights raised different issues and required in some respects different treatment. In addition, it was generally considered that in particular the recommendations dealing with anti-assignment agreements, set-off

rights of the debtor of the receivable and applicable law were not appropriate with respect to such payment rights.

149. As to the meaning of the term “financial contract” and thus as to the scope of the exclusion, differing views were expressed. One view was that a broad definition of the term “financial contract” should be adopted to ensure that all contracts encompassed by present and future practice in financial markets would be excluded from the scope of the draft Guide. It was stated that payment rights arising under or from financial contracts should be excluded whether they were subject to a netting agreement or not. It was also observed that a receivable payable upon termination of all outstanding transactions should also be excluded. In addition, it was pointed out that in particular the law applicable to a security right in such a receivable should be reviewed.

150. However, the prevailing view was that the definition of the term “financial contract” and the approach taken in the United Nations Assignment Convention (article 4, subparagraph (2) (b), and article 5, subparagraphs (k) and (l)) should be adopted. It was stated that such an approach was appropriate and would also ensure consistency with the Convention. It was also observed that, in line with the approach taken in article 4, subparagraph (2) (b), of the Convention, payment rights arising under or from financial contracts should be excluded only to the extent that they were subject to netting agreements (as a result, for example, a security right in a single receivable would not be excluded), and receivables payable upon termination of all outstanding obligations should not be excluded. In that connection, it was pointed out that the Commission, in its possible future work in that area, could examine the question of whether a special rule was required with respect to the third-party effectiveness and priority of a security right in such a receivable, as the United Nations Assignment Convention did not address that matter. However, it was added that the law applicable to a security right in such a receivable could not be reconsidered, as the United Nations Assignment Convention addressed it appropriately. While some doubt was expressed in that regard on the ground that there was a need for a new approach in view of new developments, it was widely felt that UNCITRAL could not and should not recommend an applicable law rule that would be inconsistent with the United Nations Assignment Convention.

151. The Committee agreed that security rights in payment rights arising under or from financial contracts and foreign exchange contracts should be excluded from the scope of the draft Guide based on the relevant exclusions of article 4, subparagraphs 2 (b) and (c), and the definitions of “financial contract” and “netting agreement” contained in article 5, subparagraphs (k) and (l), of the United Nations Assignment Convention. It was also agreed to recommend to the Commission that efforts should be made to consider at the resumed fortieth session of the Commission any proposals submitted in that regard. In addition, it was agreed to recommend to the Commission that it should consider at a future session possible future work on financial contracts.

12. Coordination with the draft Unidroit Model Law on Leasing

152. The Committee noted with appreciation efforts undertaken by delegates and the secretariats of Unidroit and UNCITRAL to ensure effective coordination between the draft Unidroit Model Law on Leasing and the draft Guide. It was also noted that those efforts had resulted in a proposal that the draft Model Law: defer to the draft Guide for financial leases that created a security right or an acquisition

financing right; refer to the draft Guide for the definitions of those terms; and leave applicable law issues to the draft Guide. It was also noted that, under the proposed approach, the draft Guide should cover only those financial leases that created a security right or an acquisition financing right.

153. Noting that reference should be made to the terms “retention-of-title right” and “financial lease right”, rather than to the term “acquisition financing right” (see para. 69 above), and that the term “financial lease right” was defined to ensure that only financial leases that created a security right would be covered by the draft Guide (see paras. 73-75 above), the Committee approved the proposed approach.

13. Recommendations by the Committee of the Whole to the Commission with respect to future work on the draft UNCITRAL Legislative Guide on Secured Transactions

154. Expressing once again its appreciation to the Secretariat for the preparation of an extremely large number of complex documents in a very short period of time, the Committee noted that it had adopted recommendations 4 (b) and (c) (on the scope of the draft Guide as to intellectual property, securities and financial contracts) and 74-230 (chapters VII-XIV) and approved the substance of the commentaries on chapters VII-XIV and on intellectual property, subject to the changes agreed upon by the Committee. The Committee also noted that, subject to the changes agreed upon by the Committee, it had approved the substance of the terminology of the draft Guide on the understanding that the terminology would be reviewed at the resumed fortieth session of the Commission. The Committee recommended that the Commission approve the decisions of the Committee. The Committee also recommended to the Commission that, at its resumed fortieth session, the Commission should consider recommendations 1-73 and the commentaries of chapters I-VI. In addition, the Committee recommended to the Commission that it would not need to review at its resumed fortieth session the recommendations and commentaries considered at the first part of the session, with the exception of the following materials, if necessary: recommendations on the extension of a retention-of-title right or a financial lease right to proceeds (non-unitary approach); and the commentary on the alternatives to the recommendations on the third-party effectiveness of a retention-of-title right or a financial lease right to proceeds (unitary and non-unitary approaches). A suggestion to include in the matters to be further reviewed the recommendation dealing with the law applicable to security rights in intangible property did not attract sufficient support. The Committee also recommended to the Commission that the question of whether the definitions and recommendations of the draft Guide should be reproduced, in addition to the relevant chapter of the commentaries, in a separate annex to the draft Guide, should be deferred to the resumed fortieth session.

B. Possible future work on security rights in intellectual property

155. The Committee considered a note by the Secretariat entitled “Possible future work on security rights in intellectual property” (A/CN.9/632). The Committee expressed its appreciation to the Secretariat for preparing the note and for organizing in cooperation with the World Intellectual Property Organization (WIPO) a colloquium on security rights in intellectual property,¹⁰ as requested by the

¹⁰ The UNCITRAL Second International Colloquium on Secured Transactions: Security Interests in Intellectual Property Rights, held in Vienna on 18 and 19 January 2007; for further

Commission at its thirty-ninth session.¹¹ It was noted that the colloquium, attended by representatives of Governments and of international and national governmental and non-governmental organizations with expertise in intellectual property law, had indicated the importance of intellectual property as security for credit and the need for adjustments to the draft Guide that would ensure the appropriate coordination between secured transactions and intellectual property law. It was further noted that the commentary of the draft Guide (A/CN.9/631/Add.1, para. 47) drew the attention of States to the need to consider adjusting their laws to avoid any inconsistencies between secured transactions and intellectual property law without, however, providing any specific guidance in that regard.

156. Broad support was expressed in favour of future work by the Commission on security rights in intellectual property. It was stated that a significant part of corporate wealth was embodied in intellectual property assets. It was also observed that the coordination between secured transactions law and intellectual property law under the regimes existing in many countries was not sufficiently developed to accommodate financing practices in the context of which credit was extended with intellectual property being used as security. In addition, it was said that the draft Guide did not provide sufficient guidance to States as to the adjustments that would need to be made to address the needs of financing practices relating to intellectual property. Moreover, it was emphasized that work should be undertaken as expeditiously as possible to ensure that the draft Guide gave a complete and comprehensive guidance in that regard. It was also suggested that, subject to the decision by the Commission, States might be alerted, by reference in the draft Guide, to upcoming work by the Commission on the preparation of an annex to the Guide specific to intellectual property that would modify the general considerations of the draft Guide in the same way that existing asset-specific parts of the draft Guide did so. It was finally pointed out that intellectual property law experts from Governments and from international governmental and non-governmental organizations should be invited to participate in future work in that area. There was general support for those statements and suggestions.

157. The Committee decided to recommend to the Commission that Working Group VI (Security Interests) should be entrusted with the preparation of an annex to the draft Guide specific to security rights in intellectual property. It was widely felt that the preparation of such an annex would usefully supplement the work of the Commission on the draft Guide by providing specific guidance to States as to the appropriate coordination between secured transactions and intellectual property law. The Committee was of the view that inviting international organizations with expertise in the area of intellectual property, such as WIPO, and international governmental and non-governmental organizations with expertise in secured transactions and intellectual property law to participate actively in the preparation of such an annex would help ensure the successful completion of this work within a reasonable period of time.

information about the Colloquium, see the UNCITRAL website (www.uncitral.org/uncitral/en/commission/colloquia/2secint.html).

¹¹ *Official Records of the General Assembly, Sixty-first Session, Supplement No. 17 (A/61/17)*, para. 86.

C. Decisions by the Commission with respect to agenda item 4

158. Upon recommendation of the Committee of the Whole (see para. 154 above), the Commission approved the decisions of the Committee and, subject to the changes agreed upon by the Committee, adopted recommendations 4 (b) and (c) (on the scope of the draft Guide as to intellectual property, securities and financial contracts) and 74-230 (chapters VII-XIV) and approved the substance of the commentaries on chapters VII-XIV and on intellectual property. In addition, the Commission, subject to the changes agreed upon by the Committee, approved the substance of the terminology of the draft Guide on the understanding that the terminology would be reviewed at its resumed fortieth session.

159. Upon recommendation of the Committee of the Whole (see para. 154 above), the Commission, in addition, decided that, at its resumed fortieth session, it would consider recommendations 1-73 and the commentaries of chapters I-VI. The Commission agreed that it would not need to review at that time the recommendations and commentaries considered at the first part of the session, with the exception of the following materials, if necessary: recommendations on the extension of a retention-of-title right or a financial lease right to proceeds (non-unitary approach); and the commentary on the alternatives to the recommendations on the third-party effectiveness of a retention-of-title right or a financial lease right to proceeds (unitary and non-unitary approaches). The Commission agreed to defer to its resumed fortieth session the question of whether the definitions and recommendations of the draft Guide should be reproduced, in addition to the relevant chapter of the commentaries, in a separate annex to the draft Guide.

160. With respect to securities, on the recommendation of the Committee of the Whole (see para. 147 above), the Commission decided that future work should be undertaken with a view to preparing an annex to the draft Guide on certain types of securities, taking into account work by other organizations, in particular Unidroit.

161. With respect to financial contracts, on the recommendation of the Committee of the Whole (see para. 151 above), the Commission decided that efforts should be made to consider at its resumed fortieth session any proposals submitted in that regard. In addition, it decided to consider at a future session possible future work on financial contracts.

162. With respect to future work on security rights in intellectual property, on the recommendation of the Committee of the Whole (see para. 157 above), the Commission decided to entrust Working Group VI (Security Interests) with the preparation of an annex to the draft Guide specific to security rights in intellectual property. (For the next session of the Working Group, see para. 251 (f) below.)

IV. Procurement: progress report of Working Group I

163. At its thirty-sixth and thirty-seventh sessions, in 2003 and 2004, respectively, the Commission considered the possible updating of the UNCITRAL Model Law on Procurement of Goods, Construction and Services and its Guide to Enactment¹² on

¹² Ibid., *Forty-ninth Session, Supplement No. 17* and corrigendum (A/49/17 and Corr.1), annex I; see also *UNCITRAL Model Law on Procurement of Goods, Construction and Services with Guide to Enactment* (United Nations publication, Sales No. E.05.V.10).

the basis of the notes by the Secretariat (A/CN.9/539 and Add.1 and A/CN.9/553).^{13, 14} At its thirty-seventh session, the Commission agreed that the Model Law would benefit from being updated to reflect new practices, in particular those that resulted from the use of electronic communications in public procurement, and the experience gained in the use of the Model Law as a basis for law reform in public procurement as well as possible additional issues. The Commission decided to entrust the preparation of proposals for the revision of the Model Law to its Working Group I (Procurement) and gave the Working Group a flexible mandate to identify the issues to be addressed in its considerations. The Commission noted that, in updating the Model Law, care should be taken not to depart from the basic principles of the Model Law and not to modify the provisions whose usefulness had been proven.¹⁵

164. The Working Group commenced its work pursuant to that mandate at its sixth session (Vienna, 30 August-3 September 2004). At that session, it decided to proceed with the in-depth consideration of the topics suggested in the notes by the Secretariat (A/CN.9/WG.I/WP.31 and A/CN.9/WG.I/WP.32)¹⁶ in sequence at its future sessions (A/CN.9/568, para. 10).

165. At its thirty-eighth and thirty-ninth sessions, in 2005 and 2006, respectively, the Commission took note of the reports of the sixth (Vienna, 30 August-3 September 2004), seventh (New York, 4-8 April 2005), eighth (Vienna, 7-11 November 2005) and ninth (New York, 24-28 April 2006) sessions of the Working Group (A/CN.9/568, A/CN.9/575, A/CN.9/590 and A/CN.9/595, respectively).^{17, 18}

166. At its current session, the Commission took note of the reports of the tenth (Vienna, 25-29 September 2006) and eleventh (New York, 21-25 May 2007) sessions of the Working Group (A/CN.9/615 and A/CN.9/623, respectively).

167. The Commission was informed that the Working Group, at its tenth and eleventh sessions, had continued its work on the elaboration of proposals for the revision of the Model Law and in this regard had considered the following topics: (i) the use of electronic means of communication in the procurement process; (ii) aspects of the publication of procurement-related information, including revisions to article 5 of the Model Law and the publication of forthcoming procurement opportunities; (iii) the procurement technique known as the electronic reverse auction; (iv) abnormally low tenders; and (v) the method of contracting known as the framework agreement. It used the notes by the Secretariat (A/CN.9/WG.I/WP.43 and Add.1, A/CN.9/WG.I/WP.44 and Add.1, A/CN.9/WG.I/WP.47, A/CN.9/WG.I/WP.48, A/CN.9/WG.I/WP.50 and A/CN.9/WG.I/WP.51) as a basis for its deliberations (A/CN.9/615, paras. 10 and 11, and A/CN.9/623, paras. 12 and 13).

168. The Commission was further informed that the Working Group, at its eleventh session, had held a preliminary exchange of views on document A/CN.9/WG.I/WP.52 and the drafting materials regarding framework agreements contained therein, and had decided to consider the document in depth at its next

¹³ Ibid., *Fifty-eighth Session, Supplement No. 17* (A/58/17), paras. 225-230.

¹⁴ Ibid., *Fifty-ninth Session, Supplement No. 17* (A/59/17), paras. 79-82.

¹⁵ Ibid., paras. 81 and 82.

¹⁶ Ibid., *Sixtieth Session, Supplement No. 17* (A/60/17), para. 171.

¹⁷ Ibid., paras. 170-172.

¹⁸ Ibid., *Sixty-first Session, Supplement No. 17* (A/61/17), paras. 190-192.

session. The Commission noted that the Working Group had deferred consideration of documents A/CN.9/WG.I/WP.45 and Add.1 and A/CN.9/WG.I/WP.52/Add.1 to a future session (A/CN.9/623, para. 12).

169. The Commission recalled that, at its thirty-ninth session, it had recommended that the Working Group, in updating the Model Law and the Guide, should take into account the question of conflicts of interest and should consider whether any specific provisions addressing that question in the Model Law would be warranted.¹⁹ The Commission took note of the decision of the Working Group at its tenth session to add the issue of conflicts of interest to the list of topics to be considered in the revision of the Model Law and the Guide (A/CN.9/615, para. 11), and that the Working Group, at its eleventh session, had noted that any time frame to be agreed for the completion of the revisions to the Model Law and the Guide should take into account the time necessary to consider and address this question (A/CN.9/623, para. 13).

170. The Commission commended the Working Group for the progress made in its work, and reaffirmed its support for the review being undertaken and for the inclusion of novel procurement practices and techniques in the Model Law. It recommended that the Working Group should adopt a concrete agenda for its forthcoming sessions in order to expedite progress in its work. (For the next two sessions of the Working Group, see para. 251 (a) below.)

V. Arbitration and conciliation: progress report of Working Group II

171. The Commission recalled that at its thirty-ninth session, in 2006, it had agreed that Working Group II (Arbitration and Conciliation) should undertake a revision of the UNCITRAL Arbitration Rules.²⁰

172. At that session, the Commission noted that, as one of the early instruments developed by UNCITRAL in the field of arbitration, the UNCITRAL Arbitration Rules were widely recognized as a very successful text, having been adopted by many arbitration centres and used in many different instances, for example, in investor-State disputes. In recognition of the success and status of the UNCITRAL Arbitration Rules, the Commission was generally of the view that any revision of the Rules should not alter the structure of the text, its spirit or its drafting style, and should respect the flexibility of the text rather than make it more complex. It was suggested that the Working Group should undertake to define carefully the list of topics that might need to be addressed in a revised version of the UNCITRAL Arbitration Rules.²¹

173. At its current session, the Commission commended the Working Group for the progress made regarding the revision of the UNCITRAL Arbitration Rules, as reflected in the reports of the forty-fifth (Vienna, 11-15 September 2006) and forty-sixth (New York, 5-9 February 2007) sessions of the Working Group (A/CN.9/614 and A/CN.9/619, respectively). The Commission also had before it a note by the

¹⁹ Ibid., para. 192.

²⁰ Ibid., para. 187; for the text of the UNCITRAL Arbitration Rules, see *Official Records of the General Assembly, Thirty-first Session, Supplement No. 17* (A/31/17), para. 57.

²¹ *Official Records of the General Assembly, Sixty-first Session, Supplement No. 17* (A/61/17), para. 184.

Secretariat transmitting the report of the Secretary-General of the Permanent Court of Arbitration on its activities under the UNCITRAL Arbitration Rules since 1976 (A/CN.9/634).

174. The Commission noted that the UNCITRAL Arbitration Rules had not been amended since their adoption in 1976 and that the review should seek to modernize the Rules and to promote greater efficiency in arbitral proceedings. The Commission generally agreed that the mandate of the Working Group to maintain the original structure and spirit of the UNCITRAL Arbitration Rules had provided useful guidance to the Working Group in its deliberations to date and should continue to be a guiding principle for its work.

175. The Commission noted that broad support had been expressed in the Working Group for a generic approach that sought to identify common denominators that applied to all types of arbitration irrespective of the subject matter of the dispute, in preference to dealing with specific situations. However, the Commission noted that the extent to which the revised UNCITRAL Arbitration Rules should take account of investor-State dispute settlement or administered arbitration remained to be considered by the Working Group at future sessions.

176. The Commission noted with satisfaction that the Working Group was progressing rapidly with the preparation of the revised UNCITRAL Arbitration Rules. The Working Group was expected to complete its work so that the final review and adoption of the revised Rules would take place at the latest at the forty-second session of the Commission, in 2009. It was agreed that, should the Working Group complete its proposals early enough for them to be considered by the Commission at its forty-first session, in 2008, that option would also be acceptable.

177. With respect to future work in the field of settlement of commercial disputes, the Commission recalled that, at its thirty-ninth session, it had agreed that the issue of arbitrability was a topic that the Working Group should also consider. As to the issue of online dispute resolution, it was agreed that the Working Group should maintain the topic on its agenda but, at least in an initial phase, should consider the implications of electronic communications in the context of the revision of the UNCITRAL Arbitration Rules.²²

178. The Commission was informed that 2008 would mark the fiftieth anniversary of the Convention on the Recognition and Enforcement of Foreign Arbitral Awards, done at New York on 10 June 1958²³ (the “New York Convention”) and that conferences to celebrate that anniversary were being planned in different regions, which would provide opportunities to exchange information on how the New York Convention had been implemented around the world. The Secretariat was requested to monitor the conferences and make full use of events associated with that anniversary to encourage further treaty actions in respect of the New York Convention and promote a greater understanding of that instrument. The Commission was informed that a one-day conference organized jointly by the United Nations and the International Bar Association was scheduled to be held in New York on 1 February 2008. (For the next two sessions of the Working Group, see para. 251 (b) below.)

²² Ibid., para. 187.

²³ United Nations, *Treaty Series*, vol. 330, No. 4739.

VI. Transport law: progress report of Working Group III

179. At its thirty-fourth session, in 2001, the Commission established Working Group III (Transport Law) to prepare, in close cooperation with interested international organizations, a legislative instrument on issues relating to the international carriage of goods by sea, such as the scope of application, the period of responsibility of the carrier, the obligations of the carrier, the liability of the carrier, the obligations of the shipper and transport documents.²⁴ At its thirty-fifth session, in 2002, the Commission approved the working assumption that the draft convention on transport law should cover door-to-door transport operations.²⁵ At its thirty-sixth to thirty-ninth sessions, in 2003-2006, respectively, the Commission noted the complexities involved in the preparation of the draft Convention on the Carriage of Goods [Wholly or Partly] [by Sea] and authorized the Working Group, on an exceptional basis, to hold its sessions on the basis of two-week sessions.^{26, 27, 28, 29}

180. At its current session, the Commission took note with appreciation of the progress made by the Working Group at its eighteenth (Vienna, 6-17 November 2006) and nineteenth (New York, 16-27 April 2007) sessions (for the reports of the sessions, see A/CN.9/616 and A/CN.9/621, respectively).

181. The Commission was informed that the Working Group, at its eighteenth session, had continued and largely completed its second reading of the draft Convention, and had made significant progress with respect to a number of difficult issues, including those regarding transport documents and electronic transport records, shipper's liability for delay, time for suit, limitation of the carrier's liability, the relationship of the draft Convention with other conventions, general average, jurisdiction and arbitration. Also considered by the Working Group was the issue of rights of suit pursuant to the draft Convention and it was decided that, while an attempt to offer uniform solutions for rights of suit was a laudatory goal, the chapter should be deleted from the draft Convention in the light of its complexity and of the Working Group's goal for completion of the text. The Commission was also informed that the Secretariat had facilitated consultations between experts from Working Group III (Transport Law) and experts from Working Group II (Arbitration and Conciliation) and that a common understanding had been reached that accommodated the needs and general approach of both working groups regarding the provisions on arbitration in the draft Convention.

182. The Commission was further informed that the Working Group, at its nineteenth session, had commenced its third reading of the draft Convention and that significant progress had been made in that regard. The third reading of a number of chapters of the draft Convention had been completed, including of related definitions, regarding the scope of application, electronic transport records, the period of responsibility of the carrier, the obligations of the carrier, the liability of the carrier, additional provisions relating to particular stages of carriage, the

²⁴ *Official Records of the General Assembly, Fifty-sixth Session, Supplement No. 17 and corrigendum (A/56/17 and Corr.3)*, para. 345.

²⁵ *Ibid.*, *Fifty-seventh Session, Supplement No. 17 (A/57/17)*, para. 224.

²⁶ *Ibid.*, *Fifty-eighth Session, Supplement No. 17 (A/58/17)*, para. 208.

²⁷ *Ibid.*, *Fifty-ninth Session, Supplement No. 17 (A/59/17)*, para. 133.

²⁸ *Ibid.*, *Sixtieth Session, Supplement No. 17 (A/60/17)*, para. 238.

²⁹ *Ibid.*, *Sixty-first Session, Supplement No. 17 (A/61/17)*, para. 270.

validity of contractual terms, liability for delay in the delivery of goods, the relationship of the draft Convention with other conventions and the obligations of the shipper. The Commission was further informed that the third reading had also largely been completed of the chapter regarding transport documents and electronic transport records.

183. The Commission commended the Working Group for the progress made in its work, particularly in the light of its goal of presenting the draft Convention to the Commission for its consideration in 2008. Nevertheless, some serious concerns were raised regarding the treatment of certain substantive issues in the draft Convention, such as freedom of contract in volume contracts, and it was suggested that those issues should receive further examination prior to finalization of the draft Convention. One delegation indicated that the treatment of the issue of freedom of contract in volume contracts would determine its position with regard to the adoption of a final convention.

184. With respect to the time frame for completion of the draft Convention, the Commission was informed that the Working Group planned to complete its third and final reading at the end of 2007, with a view to presenting the draft Convention for finalization by the Commission in 2008. In order to accommodate that goal and to allow for the possibility that the Working Group might need additional time beyond the end of its twentieth session to complete the final reading, the Commission agreed to schedule the twenty-first session of the Working Group for 14 to 25 January 2008, so as to provide sufficient time to complete the final reading of the draft Convention and circulate it for comments to Governments prior to the forty-first session of the Commission, in 2008. Further, the Commission agreed to move the twenty-first session of the Working Group from New York to Vienna, given that, if the final reading were completed at that session, it would require the participation of a formal drafting group, including translators and editors, which was possible only in Vienna. The Commission further noted that the Working Group could decide at the conclusion of its twentieth session whether it required a one-week or a two-week session in January 2008, but that, generally, noting the complexities and magnitude of the work involved in the preparation of the draft Convention, the Commission authorized the Working Group to hold its sessions on the basis of two-week sessions. (For the next two sessions of the Working Group, see para. 251 (c) below.)

VII. Insolvency law

A. Progress report of Working Group V

185. The Commission recalled that, at its thirty-ninth session, in 2006, it had agreed that: (a) the topic of the treatment of corporate groups in insolvency was sufficiently developed for referral to Working Group V (Insolvency Law) for consideration in 2006 and that the Working Group should be given the flexibility to make appropriate recommendations to the Commission regarding the scope of its future work and the form it should take, depending upon the substance of the proposed solutions to the problems that the Working Group would identify under that topic; and (b) post-commencement finance should initially be considered as a component of work to be undertaken on insolvency of corporate groups, with the Working

Group being given sufficient flexibility to consider any proposals for work on additional aspects of the topic.³⁰

186. The Commission noted with appreciation the progress of the Working Group regarding consideration of the treatment of corporate groups in insolvency as reflected in the reports of its thirty-first (Vienna, 11-15 December 2006) and thirty-second (New York, 14-18 May 2007) sessions (A/CN.9/618 and A/CN.9/622, respectively) and commended the Secretariat for the working papers and reports prepared for those sessions.

187. The Commission reaffirmed that the mandate of the Working Group was to consider the treatment of corporate groups in insolvency, with post-commencement finance to be included as a component of that work (see para. 185 above).

188. The Commission took note of the agreement of the Working Group, at its thirty-first session, that the Insolvency Guide³¹ and the UNCITRAL Model Law on Cross-Border Insolvency³² provided a sound basis for the unification of insolvency law and that the current work on corporate groups was intended to complement those texts, not to replace them (A/CN.9/618, para. 69). The Commission also took note of the suggestion made at that session of the Working Group that a possible method of work would be to consider the provisions contained in those existing texts that might be relevant in the context of corporate groups and identify those issues that required additional discussion and the preparation of additional recommendations. The Commission further took note that other issues, although relevant to corporate groups, could be treated in the same manner as in the Insolvency Guide and the UNCITRAL Model Law on Cross-Border Insolvency (A/CN.9/618, para. 70).

189. Concerns were expressed in the Commission with respect to some components of that work, in particular substantive consolidation and its effect on the separate identity of individual members of a corporate group. In addition, the possibility of submitting a solvent member of a corporate group to collective procedures was seriously questioned. The Commission noted those concerns and requested the Working Group to bear them in mind in its deliberations. (For the next two sessions of the Working Group, see para. 251 (e) below.)

B. Facilitation of cooperation and coordination in cross-border insolvency proceedings

190. The Commission recalled that at its thirty-ninth session, in 2006, it had agreed that initial work to compile practical experience with negotiating and using cross-border insolvency protocols should be facilitated informally through consultation with judges and insolvency practitioners and that a preliminary progress report on that work should be presented to the Commission for further consideration at its fortieth session, in 2007.³³

³⁰ Ibid., para. 209 (a) and (b).

³¹ United Nations publication, Sales No. E.05.V.10.

³² *Official Records of the General Assembly, Fifty-second Session, Supplement No. 17 (A/52/17)*, annex I.

³³ Ibid., *Sixty-first Session, Supplement No. 17 (A/61/17)*, para. 209 (c).

191. The Commission had before it a note by the Secretariat on facilitation of cooperation, direct communication and coordination in cross-border insolvency proceedings (A/CN.9/629). The Commission emphasized the practical importance of facilitating cross-border cooperation in insolvency cases. It expressed its satisfaction with respect to the progress made on the work of compiling practical experience with negotiating and using cross-border insolvency protocols based on the draft outline of contents in document A/CN.9/629. It reaffirmed that that work should continue to be developed informally by the Secretariat in consultation with judges, practitioners and other experts.

VIII. Possible future work in the area of electronic commerce

192. The Commission recalled that Working Group IV (Electronic Commerce), after it had completed its work on the draft Convention on the Use of Electronic Communications in International Contracts, in 2004, requested the Secretariat to continue monitoring various issues related to electronic commerce, including issues related to cross-border recognition of electronic signatures, and to publish the results of its research with a view to making recommendations to the Commission as to whether future work in those areas would be possible (A/CN.9/571, para. 12).

193. The Commission further recalled that, at its thirty-eighth session, in 2005, it took note of the work undertaken by other organizations in various areas related to electronic commerce, summarized in a note by the Secretariat (A/CN.9/579). At that session, the Commission requested the Secretariat to prepare a more detailed study, which should include proposals as to the form and nature of a comprehensive reference document discussing the various elements required to establish a favourable legal framework for electronic commerce, which the Commission might in the future consider preparing with a view to assisting legislators and policymakers around the world.³⁴

194. It was also recalled that at its thirty-ninth session, in 2006, the Commission had considered a note by the Secretariat prepared pursuant to that request (A/CN.9/604). The note identified the following areas as possible components of a comprehensive reference document: (a) authentication and cross-border recognition of electronic signatures; (b) liability and standards of conduct for information service providers; (c) electronic invoicing and legal issues related to supply chains in electronic commerce; (d) transfer of rights in tangible goods and other rights through electronic communications; (e) unfair competition and deceptive trade practices in electronic commerce; and (f) privacy and data protection in electronic commerce. The note also identified other issues that could be included, although in a more summary fashion, in such a document: (a) protection of intellectual property rights; (b) unsolicited electronic communications (spam); and (c) cybercrime. At that session, there had been support for the view that the task of legislators and policymakers, in particular in developing countries, might be greatly facilitated if the Commission were to formulate a comprehensive reference document dealing with the topics identified by the Secretariat. It had been also said at that session that such a document might also assist the Commission in identifying areas in which it might itself undertake future harmonization work. However, concerns had also been expressed that the range of issues identified was too wide and that the scope of the comprehensive reference document might need to be reduced. At that session, the

³⁴ Ibid., *Sixtieth Session, Supplement No. 17* (A/60/17), para. 214.

Commission had requested the Secretariat to prepare a sample portion of the comprehensive reference document dealing specifically with issues related to authentication and cross-border recognition of electronic signatures, for review at the Commission's fortieth session, in 2007.³⁵

195. At its current session, the Commission considered the sample chapter that had been prepared by the Secretariat pursuant to that request (A/CN.9/630 and Add.1-5). The Commission reviewed the structure, level of detail, nature of discussion and type of advice provided in the sample chapter. The Commission commended the Secretariat for the preparation of the sample chapter, which the Commission regarded as very informative and useful. It was suggested that it would be desirable for the Secretariat to prepare other chapters following the same model, to deal with other issues that the Commission might wish to select from among those proposed earlier, in particular the transfer of rights in tangible goods and other rights through electronic communications. However, the Commission was not in favour of requesting the Secretariat to undertake similar work in other areas with a view to preparing a comprehensive reference document. The Commission agreed to request the Secretariat to continue to follow closely legal developments in the relevant areas, with a view to making appropriate suggestions in due course. In view of the valuable work that had already been done, the Commission requested the Secretariat to publish the sample chapter as a stand-alone publication.

IX. Possible future work in the area of commercial fraud

A. Background

196. It was recalled that the Commission at its thirty-fifth to thirty-ninth sessions, from 2002 to 2006, had considered possible future work on commercial fraud^{36, 37, 38, 39, 40} It was in particular recalled that at its thirty-seventh session, in 2004, with a view towards education, training and prevention, the Commission had agreed that the preparation of lists of common features present in typical fraudulent schemes could be useful as educational material for participants in international trade and other potential targets of perpetrators of fraud to the extent that such lists would help potential targets protect themselves and avoid becoming victims of fraudulent schemes. While it was not proposed that the Commission itself or its intergovernmental working groups should be directly involved in that activity, it was agreed that the Secretariat should consider preparing, in close consultation with experts, such materials listing common features present in typical fraudulent schemes and that the Secretariat would keep the Commission informed of progress in that regard.⁴¹

197. It was further recalled that the attention of the Commission had been drawn at its thirty-eighth session, in 2005, to Economic and Social Council resolution 2004/26 of 21 July 2004, pursuant to which the United Nations Office on Drugs and

³⁵ Ibid., *Sixty-first Session, Supplement No. 17* (A/61/17), paras. 203-206.

³⁶ Ibid., *Fifty-seventh Session, Supplement No. 17* (A/57/17), paras. 279-290.

³⁷ Ibid., *Fifty-eighth Session, Supplement No. 17* (A/58/17), paras. 231-241.

³⁸ Ibid., *Fifty-ninth Session, Supplement No. 17* (A/59/17), paras. 108-112.

³⁹ Ibid., *Sixtieth Session, Supplement No. 17* (A/60/17), paras. 216-220.

⁴⁰ Ibid., *Sixty-first Session, Supplement No. 17* (A/61/17), paras. 211-217.

⁴¹ Ibid., *Fifty-ninth Session, Supplement No. 17* (A/59/17), para. 112.

Crime (UNODC) had convened an intergovernmental expert group meeting in March 2005 to prepare a study on fraud and the criminal misuse and falsification of identity, and to develop on the basis of such a study relevant practices, guidelines or other materials, taking into account in particular the relevant work of UNCITRAL.⁴² The results of that meeting were reported to the Commission on Crime Prevention and Criminal Justice (the “Crime Commission”) at its fourteenth session (Vienna, 23-27 May 2005) (E/CN.15/2005/11), where it was agreed that a study of the problem should be undertaken on the basis of the responses received to a questionnaire on fraud and the criminal misuse and falsification of identity. The UNCITRAL secretariat had participated in the expert group meeting, the progress of which was reported to the Crime Commission at its fifteenth session (Vienna, 24-28 April 2006) (E/CN.15/2006/11 and Corr.1). As the UNCITRAL secretariat had worked with UNODC in the drafting and dissemination of the questionnaire in preparation for the study, the Commission expressed its support for the assistance of the UNCITRAL secretariat in the UNODC project.⁴³

198. It was also recalled that, at its thirty-ninth session, in 2006, the Commission heard a progress report on work by the Secretariat on materials listing common features present in typical fraudulent schemes. At that session, the Commission took note of the suggested format for the materials as set out in document A/CN.9/600, paragraph 14, and that the materials could contain additional information, such as explanations regarding how to effectively perform due diligence (A/CN.9/600, para. 16). The Commission agreed with statements made at that session to the effect that commercial fraud deterred legitimate trade and undermined confidence in established contract practices and instruments and that the UNCITRAL transactional and private law perspective and expertise were necessary for a full understanding of the problem of commercial fraud and were most useful in the formulation of measures to fight it. The Commission concluded that its secretariat should continue its work in conjunction with experts and other interested organizations with respect to identifying common features of fraudulent schemes, with a view to presenting interim or final materials for the consideration of the Commission at a future session; it should continue to cooperate with UNODC in its study on fraud, the criminal misuse and falsification of identity and related crimes; and it should keep the Commission informed of the progress of that work.⁴⁴

B. Work on indicators of commercial fraud

199. At its current session, the Commission was informed that the Secretariat had, as requested, continued its work in conjunction with experts and other interested organizations with respect to identifying common features of fraudulent schemes in order to prepare materials of an educational nature for the purpose of preventing the success of fraudulent schemes. The results of that work were reflected in a note by the Secretariat entitled “Indicators of commercial fraud” (A/CN.9/624 and Add.1 and 2). It was explained that, as noted in the introduction to the materials before the Commission (A/CN.9/624, annex, chapter I), the intended audience was very broad and included individuals, professionals, businesspersons, regulators, law enforcement officers, litigants and, potentially, arbitration tribunals and courts in cases involving commercial fraud. It was further explained that the materials were

⁴² Ibid., *Sixtieth Session, Supplement No. 17* (A/60/17), para. 217.

⁴³ Ibid., paras. 218-219.

⁴⁴ Ibid., *Sixty-first Session, Supplement No. 17* (A/61/17), paras. 214-217.

intended to be instructive reference materials to provide guidance to the intended audience, regardless of their particular level of sophistication with respect to investments or commercial transactions. The presentation of each of the indicators was similar: first, the potential indicator of fraud was identified; this was followed by a more detailed description of the indicators; and, lastly, instances and examples of the particular indicator were given, as found in a commercial fraud in a variety of contexts. Advice was then provided regarding what could be done to avoid or to counteract the effects of the behaviour identified in each indicator, as appropriate. Finally, since it was not possible to identify discrete indicators with absolutely clear demarcations between them, it was explained that many of the indicators could or should overlap, and cross references to other related indicators were included, where relevant. However, the Commission was also informed that, as noted in the introduction to the materials, each of the indicators taken alone or in combination was not intended to indicate definitively the presence of commercial fraud; rather, the presence of a single warning sign was intended to send a signal that commercial fraud was a possibility, while the presence of several of the indicators was intended to heighten that concern. The Commission was informed that the text of the indicators of commercial fraud that was before it was an interim text, and that it was proposed to the Commission that the indicators of commercial fraud should be circulated by the Secretariat to Governments, international organizations and interested bodies for comment, and for consideration by the Commission at its next session.

200. The Commission commended the Secretariat, the experts and the other interested organizations that had collaborated on the preparation of the indicators of commercial fraud for their work on the difficult task of identifying the issues and in drafting materials that could be of great educational and preventive benefit. The Commission agreed with the proposal to circulate the materials on indicators of commercial fraud prior to the next session of the Commission for comment, and welcomed the opportunity to consider the document and related comments at its next session. At the same time, concern was expressed regarding future work in the area of commercial fraud, given that other international organizations, including UNODC, were working on the problem of commercial fraud and its impact. It was suggested that commercial fraud was primarily a concern of criminal law and that any future work in the area by UNCITRAL should bear in mind the mandate of UNCITRAL and whether it was possible for it to make a contribution in the area. Other views were expressed along the lines that broad cooperation and dialogue between criminal law authorities and commercial law interests with respect to commercial fraud had not been achieved until UNCITRAL had commenced its work on the indicators and its cooperation with UNODC and that that cooperation was critical to maintaining a constructive dialogue on commercial fraud and sharing information in an effective manner. It was suggested that UNCITRAL, in providing information and education on commercial fraud, had made a useful contribution to strengthening efforts to reduce the impact of fraud globally.

C. Collaboration with the United Nations Office on Drugs and Crime with respect to commercial and economic fraud

201. The Commission had before it for information the report of the Secretary-General on the results of the second meeting of the Intergovernmental Expert Group

to Prepare a Study on Fraud and the Criminal Misuse and Falsification of Identity (E/CN.15/2007/8 and Add.1-3), held in Vienna from 16 to 19 January 2007.

202. The Commission was informed that the study confirmed the difficulty of measuring fraud, and that most Governments underestimated the seriousness of that rapidly expanding global problem, which was associated with the increasing use of information technology. In addition, it was noted in the study that Governments were concerned about commercial entities sometimes being reluctant to report incidents of fraud and that the high proceeds and low risks involved had made fraud attractive to both organized criminal organizations and terrorist organizations. The Commission was informed that the Crime Commission had considered the study at its sixteenth session.⁴⁵ At that session, the Crime Commission proposed for adoption by the Economic and Social Council a draft resolution by which the Council would: (a) request the Secretary-General to disseminate its report containing the conclusions of the study as widely as possible; (b) encourage Member States to take a number of actions, including availing themselves of the recommendations of the report when developing effective strategies for responding to the problems addressed in the report and consulting and collaborating with appropriate commercial and other private-sector entities to the extent feasible, with a view to more fully understanding the problems of economic fraud and identity-related crime and cooperating more effectively in the prevention, investigation and prosecution of such crime; (c) encourage the promotion of mutual understanding and cooperation between public- and private-sector entities through initiatives aimed at bringing together various stakeholders and facilitating the exchange of views and information among them; and (d) request UNODC to facilitate such cooperation in consultation with the UNCITRAL secretariat, pursuant to Economic and Social Council resolution 2004/26 of 21 July 2004.⁴⁶

203. The Commission noted with interest and appreciation the report of the Secretary-General and the draft resolution proposed by the Crime Commission for adoption by the Economic and Social Council. The Commission requested the Secretariat to continue to cooperate with and to assist UNODC in its work with respect to commercial and economic fraud and to report to the Commission regarding any developments or efforts made in that respect.

X. Monitoring implementation of the New York Convention

204. The Commission recalled that, at its twenty-eighth session, in 1995, it had approved a project, undertaken jointly with Committee D (now known as the Arbitration Committee) of the International Bar Association, aimed at monitoring the legislative implementation of the New York Convention.⁴⁷ It was also recalled that the Secretariat had presented an interim report to the Commission at its thirty-eighth session, in 2005 (A/CN.9/585), which set out the issues raised by the

⁴⁵ See the report on the sixteenth session of the Commission on Crime Prevention and Criminal Justice (E/2007/30, chap. III), to be issued subsequently as *Official Records of the Economic and Social Council, 2007, Supplement No. 10* (E/2007/30/Rev.1).

⁴⁶ E/2007/30, chap. I, sect. B, draft resolution II.

⁴⁷ *Official Records of the General Assembly, Fiftieth Session, Supplement No. 17* (A/50/17), paras. 401-404.

replies received in response to the questionnaire circulated in connection with the project.⁴⁸

205. It was further recalled that the Commission, at its thirty-eighth session, had welcomed the progress reflected in the interim report, noting that the general outline of replies received had served to facilitate discussions as to the next steps to be taken and highlighted areas of uncertainty where more information could be sought from States parties or further studies could be undertaken. It was suggested that one possible future step could be the development of a legislative guide to limit the risk that State practice would diverge from the spirit of the New York Convention.⁴⁹

206. It was noted that, at its thirty-ninth session, in 2006, the Commission had taken note of an oral presentation by the Secretariat on additional questions it proposed to put to States (as noted in document A/CN.9/585, para. 73) in order to obtain more comprehensive information regarding various aspects of implementation of the New York Convention, including legislation, case law and practice. The Commission had agreed at that session that the project should aim at the development of a legislative guide, with a view to promoting a uniform interpretation of the New York Convention. At the same session, the Commission had reaffirmed the decisions made at its thirty-eighth session, in 2005, that a level of flexibility should be left to the Secretariat in determining the time frame for completion of the project and the level of detail that should be reflected in the report that the Secretariat would present for consideration by the Commission in due course.⁵⁰

207. At its current session, the Commission was informed that a written report was intended to be presented at its forty-first session, in 2008, which would coincide with the fiftieth anniversary of the New York Convention. The Commission commended the Secretariat for the work accomplished so far in respect of that project. The Commission was further informed that the Arbitration Committee of the International Bar Association had proposed to actively assist the Secretariat in gathering information required to complete the report. The Commission further noted that the Commission on Arbitration of the International Chamber of Commerce had created a task force to examine the national rules of procedure for recognition and enforcement of foreign arbitral awards on a country-by-country basis, with the aim of issuing in 2008 a report on national rules of procedure. The Commission encouraged the Secretariat to seek possible cooperation with the International Chamber of Commerce in order to avoid duplication of work in that respect.

208. It was proposed that, in the context of monitoring implementation of the New York Convention, the recommendation adopted by the Commission at its thirty-ninth session, in 2006,⁵¹ regarding the interpretation of article II, paragraph 2, and article VII, paragraph 1, of the New York Convention be circulated to States in order to seek comments as to the impact of that recommendation in their jurisdictions. That proposal received support.

⁴⁸ Ibid., *Sixtieth Session, Supplement No. 17* (A/60/17), para. 189.

⁴⁹ Ibid., paras. 190 and 191.

⁵⁰ Ibid., *Sixty-first Session, Supplement No. 17* (A/61/17), para. 220.

⁵¹ Ibid., annex II.

XI. Endorsement of texts of other organizations: Unidroit Principles of International Commercial Contracts 2004

209. The Commission recalled its decision made at its thirty-ninth session, in 2006, that the 2004 edition of the Unidroit Principles of International Commercial Contracts⁵² be circulated to States with a view to possible endorsement by the Commission at its current session.⁵³ The Commission noted that, pursuant to that decision, the Secretariat had circulated the text of the Principles to all States.

210. The Commission noted that the Principles, first published in 1994, provided a comprehensive set of rules for international commercial contracts. It further noted that the new edition, completed in 2004, contained five new chapters and revisions to take into account electronic contracting. The Commission recognized that the Unidroit Principles 2004 complemented a number of international trade law instruments, including the United Nations Convention on Contracts for the International Sale of Goods (1980).⁵⁴ It was observed that unofficial translations of the Principles had been published in over 12 languages, including all official languages of the United Nations except Arabic. The observer for Unidroit indicated that a version in Arabic was expected to be published in the near future.

211. General support was expressed for recognizing the value of the Unidroit Principles 2004. It was noted that the Principles were widely recognized and had been applied in a variety of circumstances. A question was raised as to the relationship between the United Nations Sales Convention and the Principles. It was observed that the United Nations Sales Convention contained comprehensive specialized rules governing contracts for the international sale of goods and applied in accordance with its scope-of-application provisions to the exclusion of the Principles. Equally, questions concerning matters governed by the United Nations Sales Convention that were not expressly settled in it were to be settled, as provided in article 7 of the Convention, in conformity with the general principles on which the Convention was based or, in the absence of such principles, in conformity with the law applicable by virtue of the rules of private international law. Thus, the optional use of the Principles was subordinate to the rules governing the applicability of the United Nations Sales Convention.

212. It was noted that the preamble of the Principles referred to their application “when the parties have agreed that their contract be governed by general principles of law, the *lex mercatoria* or the like”. It was clarified that, depending on the circumstances, the Principles might be regarded as one possible expression of the *lex mercatoria* but that that issue ultimately depended on applicable law, existing contractual arrangements and the interpretation taken by users of the Principles.

213. Bearing in mind the above considerations, the Commission, at its 851st meeting, on 4 July 2007, adopted the following decision regarding the Unidroit Principles 2004:

⁵² Available on the Unidroit website (www.unidroit.org/english/principles/contracts/main.htm).

⁵³ *Official Records of the General Assembly, Sixty-first Session, Supplement No. 17 (A/61/17)*, para. 234.

⁵⁴ United Nations, *Treaty Series*, vol. 1489, No. 25567.

“The United Nations Commission on International Trade Law,

“Expressing its appreciation to the International Institute for the Unification of Private Law (Unidroit) for transmitting to it the text of the 2004 edition of the Unidroit Principles of International Commercial Contracts,

“Taking note that the Unidroit Principles 2004 complement a number of international trade law instruments, including the United Nations Convention on Contracts for the International Sale of Goods (1980),

“Noting that the preamble of the Unidroit Principles 2004 states that the Unidroit Principles 2004 set forth general rules for international contracts and that:

“They shall be applied when the parties have agreed that their contract be governed by them,

*“They may be applied when parties have agreed that their contract be governed by general principles of law, the *lex mercatoria* or the like,*

“They may be applied when the parties have not chosen any law to govern their contract,

“They may be used to interpret or supplement international uniform law instruments,

“They may be used to interpret or supplement domestic law,

“They may serve as a model for national and international legislators,

“Congratulating Unidroit on having made a further contribution to the facilitation of international trade by preparing general rules for international commercial contracts,

“Commends the use of the Unidroit Principles 2004, as appropriate, for their intended purposes.”

XII. Technical assistance to law reform

A. Technical cooperation and assistance activities

214. The Commission had before it a note by the Secretariat (A/CN.9/627) describing the technical cooperation and assistance activities undertaken subsequent to the date of the note on that topic submitted to the Commission at its thirty-ninth session, in 2006 (A/CN.9/599). The Commission emphasized the importance of such technical cooperation and expressed its appreciation for the activities undertaken by the Secretariat referred to in document A/CN.9/627, paragraphs 6-28.

215. The Commission noted that the continuing ability to participate in technical cooperation and assistance activities in response to specific requests of States was dependent upon the availability of funds to meet associated UNCITRAL costs. The Commission in particular noted that, despite efforts by the Secretariat to solicit new donations, funds remaining in the UNCITRAL Trust Fund for Symposia would be sufficient only for technical cooperation and assistance activities already planned for 2007. Beyond the end of 2007, requests for technical cooperation and assistance involving the expenditure of funds for travel or to meet other associated costs would

have to be declined unless new donations to the Trust Fund were received or other alternative sources of funds could be found.

216. The Commission reiterated its appeal to all States, international organizations and other interested entities to consider making contributions to the UNCITRAL Trust Fund for Symposia, if possible in the form of multi-year contributions, or as specific-purpose contributions, so as to facilitate planning and enable the Secretariat to meet the increasing requests from developing countries and countries with economies in transition for technical assistance and cooperation activities. The Commission expressed its appreciation to Mexico and Singapore for contributing to the Trust Fund since the Commission's thirty-ninth session and to organizations that had contributed to the programme by providing funds or by hosting seminars. The Commission also expressed its appreciation to France and the Republic of Korea, which had funded junior professional officers to work in the Secretariat.

217. The Commission also appealed to the relevant bodies of the United Nations system, organizations, institutions and individuals to make voluntary contributions to the trust fund established to provide travel assistance to developing countries that were members of the Commission, noting that no contributions to the trust fund for travel assistance had been received since the thirty-sixth session of the Commission.

B. Technical assistance resources

218. The Commission noted with appreciation the continuing work under the system established for the collection and dissemination of case law on UNCITRAL texts (CLOUT). As at 18 April 2007, 63 issues of compiled case-law abstracts from the CLOUT system had been prepared for publication, dealing with 686 cases relating mainly to the United Nations Sales Convention and the UNCITRAL Model Law on International Commercial Arbitration.⁵⁵

219. It was widely agreed that the CLOUT system continued to be an important aspect of the overall technical assistance activities undertaken by UNCITRAL and that its broad dissemination in all six official languages of the United Nations promoted the uniform interpretation and application of UNCITRAL texts. The Commission expressed its appreciation to the national correspondents and other contributors for their work in developing the CLOUT system.

220. The Commission noted that the digest of case law on the United Nations Sales Convention, published in December 2004,⁵⁶ had been reviewed and edited and that the revised draft would be presented to the CLOUT national correspondents meeting on 5 July 2007.

221. The Commission also noted developments with respect to the UNCITRAL website (www.uncitral.org), emphasizing its importance as a component of the overall UNCITRAL programme of information and technical assistance activities. The Commission expressed its appreciation for the availability of the website in the six official languages of the United Nations and encouraged the Secretariat to maintain and further upgrade the website in accordance with existing guidelines.

⁵⁵ *Official Records of the General Assembly, Fortieth Session, Supplement No. 17 (A/40/17)*, annex I.

⁵⁶ Available on the UNCITRAL website (www.uncitral.org/uncitral/en/case_law/digests/cisg.html).

It was noted that, since the holding of the thirty-ninth session of the Commission, the website had received on average more than 2,500 visitors per day.

222. The Commission took note of developments with respect to the UNCITRAL Law Library and UNCITRAL publications.

XIII. Status and promotion of UNCITRAL legal texts

223. The Commission considered the status of the conventions and model laws emanating from its work and the status of the New York Convention, on the basis of a note by the Secretariat (A/CN.9/626) and updated information available on the UNCITRAL website. The Commission noted with appreciation the new actions and enactments of States and jurisdictions since its thirty-ninth session regarding the following instruments:

(a) [Unamended] Convention on the Limitation Period in the International Sale of Goods, 1974 (New York):⁵⁷ new action by Montenegro; 27 States parties;

(b) United Nations Convention on the Carriage of Goods by Sea, 1978 (Hamburg):⁵⁸ new action by Albania; 32 States parties;

(c) United Nations Convention on Contracts for the International Sale of Goods (1980):⁵⁹ new actions by El Salvador, Montenegro and the former Yugoslav Republic of Macedonia; 70 States parties;

(d) United Nations Convention on the Use of Electronic Communications in International Contracts (2005):⁶⁰ signatures by China, Madagascar, Paraguay, the Russian Federation, Sierra Leone, Singapore and Sri Lanka;

(e) Convention on the Recognition and Enforcement of Foreign Arbitral Awards (1958):⁶¹ new actions by the Bahamas, Gabon, the Marshall Islands, Montenegro and the United Arab Emirates; 142 States parties;

(f) UNCITRAL Model Law on International Commercial Arbitration (1985):⁶² legislation enacted by Cambodia (2006), Estonia (2006), Uganda (2000) and Venezuela (Bolivarian Republic of) (1998) based on the Model Law;

(g) UNCITRAL Model Law on Procurement of Goods, Construction and Services (1994):⁶³ legislation enacted by Afghanistan (2006) based on the Model Law;

(h) UNCITRAL Model Law on Electronic Commerce (1996):⁶⁴ legislation enacted by the United Arab Emirates (2006) and Viet Nam (2005) based on the Model Law;

⁵⁷ United Nations, *Treaty Series*, vol. 1511, No. 26119; see also *Official Records of the United Nations Conference on Prescription (Limitation) in the International Sale of Goods, New York, 20 May-14 June 1974* (United Nations publication, Sales No. E.74.V.8), part I.

⁵⁸ United Nations, *Treaty Series*, vol. 1695, No. 29215.

⁵⁹ *Ibid.*, vol. 1489, No. 25567.

⁶⁰ United Nations publication, Sales No. E.07.V.2.

⁶¹ United Nations, *Treaty Series*, vol. 330, No. 4739.

⁶² *Official Records of the General Assembly, Fifty-second Session, Supplement No. 17 (A/52/17)*, annex I.

⁶³ *Ibid.*, *Forty-ninth Session, Supplement No. 17* and corrigendum (A/49/17 and Corr.1), annex I.

(i) UNCITRAL Model Law on Cross-Border Insolvency (1997):⁶⁵ legislation enacted by Colombia (2006) and New Zealand (2006) based on the Model Law;

(j) UNCITRAL Model Law on Electronic Signatures (2001):⁶⁶ legislation enacted by the United Arab Emirates (2006) and Viet Nam (2005) based on the Model Law.

224. The Commission heard that, in the context of the treaty event⁶⁷ to be held from 25 to 27 September and on 1 and 2 October 2007, the following three treaties related to the work of UNCITRAL would be highlighted: the New York Convention, the United Nations Sales Convention and the United Nations Convention on the Use of Electronic Communications in International Contracts.

225. States were invited to consider participating in the 2007 treaty event by undertaking appropriate treaty actions relating to those treaties. In particular, it was recalled that the United Nations Convention on the Use of Electronic Communications in International Contracts would close for signature on 16 January 2008 and that therefore the 2007 treaty event might provide one of the last high-level opportunities for signature of that text.

XIV. Coordination and cooperation

A. General

226. The Commission had before it a note by the Secretariat (A/CN.9/628 and Add.1) providing a brief survey of the work of international organizations related to the harmonization of international trade law, focusing upon substantive legislative work. The Commission commended the Secretariat for the preparation of that document, recognizing its value to coordination of the activities of international organizations in the field of international trade law, and welcomed the revision of the survey on an annual basis.

227. It was recalled that the Commission at its thirty-seventh session, in 2004, had agreed that it should adopt a more proactive attitude, through its Secretariat, to fulfilling its coordination role.⁶⁸ Recalling the endorsement by the General Assembly, most recently in its resolution 61/32 of 4 December 2006, paragraph 5, of UNCITRAL efforts and initiatives towards coordination of activities of international organizations in the field of international trade law, the Commission noted with appreciation that the Secretariat was taking steps to engage in a dialogue, on both legislative and technical assistance activities, with a number of organizations,

⁶⁴ Ibid., *Fifty-first Session, Supplement No. 17* (A/51/17), annex I; see also *UNCITRAL Model Law on Electronic Commerce with Guide to Enactment 1996 with Additional Article 5 bis as Adopted in 1998* (United Nations publication, Sales No. E.99.V.4).

⁶⁵ *Official Records of the General Assembly, Fifty-second Session, Supplement No. 17* (A/52/17), annex I.

⁶⁶ Ibid., *Fifty-sixth Session, Supplement No. 17* and corrigendum (A/56/17 and Corr.3), annex II.

⁶⁷ The treaty event is a yearly exercise aimed at promoting the international rule of law through broader participation in multilateral treaties deposited with the Secretary-General. It usually takes place at United Nations Headquarters during the general debate of the General Assembly.

⁶⁸ *Official Records of the General Assembly, Fifty-ninth Session, Supplement No. 17* (A/59/17), paras. 113-115.

including the Hague Conference on Private International Law, the Organization for Economic Cooperation and Development, the Organization of American States, Unidroit, the World Bank and the World Trade Organization. The Commission noted that that work often involved travel to meetings of those organizations and the expenditure of funds allocated for official travel. The Commission reiterated the importance of coordination work being undertaken by UNCITRAL as the core legal body in the United Nations system in the field of international trade law and supported the use of travel funds for that purpose.

B. Reports of other international organizations

228. The Commission heard a statement on behalf of Unidroit, reporting on progress with a number of projects outlined in document A/CN.9/628 and Add.1, including the following:

(a) The Working Group on the Principles of International Commercial Contracts held its second session in June 2007 and made substantial progress on the unwinding of failed contracts, plurality of obligors and of obligees, termination of long-term contracts for just cause and initial progress on illegality. An intersessional meeting of a drafting committee would be held;

(b) The fourth session of the Unidroit Committee of Governmental Experts was held in May 2007 to further consider the draft Convention on Substantive Rules regarding Intermediated Securities. That meeting considered a number of additional systems regulating the trading, custody, clearing and settlement of securities, including in Asia (China and Malaysia), Europe (Spain and several Nordic countries) and Latin America (Brazil and Colombia). A diplomatic conference was scheduled for 2 to 13 June 2008;

(c) The drafting of a legislative guide on principles and rules on trading in securities in emerging markets was currently suspended to concentrate on the draft Convention on Substantive Rules regarding Intermediated Securities;

(d) The Convention on International Interests in Mobile Equipment (2001)⁶⁹ and the Protocol to that Convention on Matters specific to Aircraft Equipment (2001)⁷⁰ each currently had 16 States parties. The Diplomatic Conference to Adopt a Rail Protocol to the Convention on International Interests in Mobile Equipment, held in Luxembourg from 12 to 23 February 2007, adopted the Luxembourg Protocol to the Convention on International Interests in Mobile Equipment on Matters specific to Railway Stock (2007).⁷¹ The Luxembourg Protocol had been signed by four States on 23 February 2007, the date of adoption. The third session of the Unidroit Committee of Governmental Experts, expected to be held in late 2007, would continue to discuss the preliminary draft protocol on matters specific to space assets;

(e) The relationship between the Convention on International Interests in Mobile Equipment and the Protocols thereto and the draft Unidroit Model Law on

⁶⁹ Available on the Unidroit website (www.unidroit.org/english/conventions/mobile-equipment/main.htm).

⁷⁰ Available on the Unidroit website (www.unidroit.org/english/conventions/mobile-equipment/main.htm).

⁷¹ Available on the Unidroit website (www.unidroit.org/english/conventions/mobile-equipment/main.htm).

Leasing continued to be examined, most recently by the Unidroit Committee of Governmental Experts in Johannesburg, South Africa. A further session was scheduled for December 2007 or early 2008, and it was anticipated that the Unidroit General Assembly would consider the draft Model Law in early 2008.

XV. Willem C. Vis International Commercial Arbitration Moot competition

229. It was noted that the Institute of International Commercial Law at Pace University School of Law in White Plains, New York, had organized the Fourteenth Willem C. Vis International Commercial Arbitration Moot in Vienna, from 30 March to 5 April 2007. As in previous years, the Moot had been co-sponsored by the Commission. It was noted that legal issues dealt with by the teams of students participating in the Fourteenth Moot had been based on the United Nations Sales Convention,⁷² the Arbitration Rules of the Court of International Commercial Arbitration attached to the Chamber of Commerce and Industry of Romania,⁷³ the Arbitration Model Law⁷⁴ and the New York Convention.⁷⁵ A total of 177 teams from law schools in 51 countries had participated in the Fourteenth Moot. The best team in oral arguments was that of the University of Freiburg, Germany. The Fifteenth Willem C. Vis International Commercial Arbitration Moot would be held in Vienna from 14 to 20 March 2008.

XVI. Relevant General Assembly resolutions

230. The Commission took note with appreciation of General Assembly resolutions 61/32, on the report of the Commission on the work of its thirty-ninth session, and 61/33 of 4 December 2006, on the revised articles of the Model Law on International Commercial Arbitration, and of the recommendation regarding the interpretation of article II, paragraph 2, and article VII, paragraph 1, of the New York Convention.⁷⁶

231. The Commission also took note of General Assembly resolution 61/39 of 4 December 2006, on the rule of law at the national and international levels, and heard an oral report from the Secretariat on the status of implementation of the resolution. In particular, as regards the preparation of an inventory requested by the General Assembly in the resolution, the Commission noted that the UNCITRAL secretariat, based on replies to a circulated questionnaire, had submitted a detailed inventory of all activities of UNCITRAL and its secretariat related to the promotion of the rule of law at the national and international levels, and, as was requested, identified problems commonly encountered in those activities and possible solutions.

⁷² United Nations, *Treaty Series*, vol. 1489, No. 25567.

⁷³ Available on the website of the Chamber of Commerce and Industry of Romania (<http://arbitration.ccir.ro/engleza/rulesarb.htm>).

⁷⁴ *Official Records of the General Assembly, Fortieth Session, Supplement No. 17 (A/40/17)*, annex I.

⁷⁵ United Nations, *Treaty Series*, vol. 330, No. 4739.

⁷⁶ *Ibid.*

232. The Commission was apprised of the pertinent statement made by the Chairman of the thirty-ninth session of the Commission at the sixty-first session of the General Assembly upon introduction of the annual report of the Commission to the Sixth Committee of the Assembly. The Commission was informed that the Chairman, in his statement made on behalf of UNCITRAL, had welcomed consideration in a comprehensive and coherent manner by the Assembly of ways and means to promote the rule of law at the national and international levels. He noted current sporadic and fragmented approaches within the United Nations in that regard. With the primary focus on criminal justice, transitional justice and judicial reform, these approaches, he stated, often overlooked the economic dimension of the rule of law, including the need for commercial law reforms as an essential foundation for long-term stability, development, empowerment and good governance. He further stated that, as United Nations experience in various areas of its operation had shown, approaches to building and promoting the rule of law had to be comprehensive and coherent in order to achieve sustained results.

233. The Commission reiterated its conviction that its work to establish modern private law standards on international trade in a manner that was acceptable to States with different legal, social and economic systems and to promote such standards significantly contributed to the development of harmonious international relations, respect for the rule of law, peace and stability, and was indispensable for supporting economic development and for designing a sustainable economy. It therefore highlighted the need for more effective integration of resources and expertise of UNCITRAL, as the only United Nations expert body in the field of international commercial law, in the programmes within and outside the United Nations aimed at promoting the rule of law at the national and international levels. The hope was expressed that the areas of work, resources and expertise of UNCITRAL, together with the problems encountered in the implementation of its mandate and the actions and resources needed to overcome those problems, would be duly taken into account in the implementation of General Assembly resolution 61/39.

XVII. Other business

A. Observations and proposals by France on the methods of work of the Commission

234. The Commission had before it observations and proposals by France on the working methods of the Commission (A/CN.9/635). It was stated by the proponents that the fortieth anniversary of the Commission was a particularly timely moment to review its working methods, which were said to be uncertain and to deviate from rules of procedure generally followed by subsidiary organs of the General Assembly. Of particular concern to the proponents of such a review was the perception that the working methods of the Commission and its working groups might not sufficiently encourage effective participation in the creation of UNCITRAL standards or the subsequent enactment of those standards by a broad range of States. Examples were given of instruments adopted by UNCITRAL that had so far not been widely ratified or enacted by States. The proposed changes in the working methods of the Commission were described as a means through which member States might increase their sense of ownership and responsibility in respect of UNCITRAL through stronger control over the standard-making activity of the

Commission. Among the various proposals outlined in the observations by France, emphasis was placed on the decision-making process in the Commission and its working groups. From the point of view of the delegation of France, it was appropriate to better define the notion “consensus”, on which the decision-making process was based. The role of non-State entities in the elaboration of uniform law standards was also questioned and it was proposed that a clearer distinction should be made between the phase of negotiation, during which non-governmental organizations might make useful contributions, and the phase of decision-making, in which only member States should take part.

235. In response to those observations and proposals, it was stated that any input aimed at maintaining the tradition of excellence of UNCITRAL and ensuring its effectiveness should be welcomed. It was pointed out that, as a technical body, UNCITRAL had decided in its earliest sessions that it would develop working methods that were appropriate for the performance of its functions. Over its 40 years of existence, it had developed several conventions, model laws, legislative guides and other standards with input from elected members from all regions of the world. As a result, UNCITRAL texts had been welcomed and adopted all over the world. It was recalled that the nature of UNCITRAL work (namely, the field of private law) required expert input from professional associations outside governments who had insight into the areas of law being considered for work by the Commission. In view of the need for the participation of such observers from private international associations, the Commission was urged to prevent any circumstances that could affect their willingness to participate in UNCITRAL meetings. It was noted that recognizing the key role of participants from non-State entities and encouraging their continued input was not incompatible with clarifying to invited non-governmental organizations their role as contributors and not decision-makers. It was also stated that the fact that UNCITRAL decisions had so far been made without the need for a vote should be regarded as a positive feature that reflected efforts to seek commonly acceptable solutions as opposed to quick results through voting. By seeking to find solutions that were acceptable to a broad spectrum of countries, UNCITRAL had avoided entrenched disagreements and had been an effective standard-setting organization.

236. In the general discussion that ensued, it was widely felt that, while the current working methods had demonstrated their efficiency, a comprehensive review of the working methods of the Commission might be timely, particularly in view of the recent increase in membership of the Commission and the number of topics being dealt with by the Commission and its six full-membership working groups to which non-member States also were invited. It was agreed that the guiding principles for such a comprehensive review should be those of inclusiveness, transparency and flexibility. Tolerance and professionalism were also mentioned. Particular mention was made of the need to preserve flexibility and discretion in the adjustment of its working methods by the Secretariat. Views were also expressed to the effect that existing rules of procedure of the Commission were insufficiently known, characterized by a high degree of flexibility and informality, and difficult to access and to assess.

237. It was suggested that continuation of the discussion might be greatly facilitated if the Secretariat could present a compilation of procedural rules and practices established by UNCITRAL itself or by the General Assembly in its resolutions regarding the work of the Commission. The Commission requested the

Secretariat to prepare such a document for consideration by the Commission, if possible as early as its resumed fortieth session.

238. As to the substance of the proposals, various views were expressed. With respect to the decision-making process, while general preference was expressed in favour of adopting decisions by consensus, it was stated that further clarification might be required, in particular regarding the possibility of better reflecting the views of minorities and the criteria to be applied by chairpersons in assessing the level of consensus or in recognizing the exceptional circumstances where voting might be unavoidable. In that context, it was suggested that one could envisage the preparation of a comprehensive set of rules of procedure or a set of principles or guidelines to be applied by the Commission and its subsidiary bodies.

239. With respect to participation by non-governmental organizations, it was generally agreed that active participation from relevant commercial circles represented by invited non-governmental organizations was essential to the quality of the work of UNCITRAL. It was suggested that attention should be given to establishing rules to guarantee transparency in the selection of such organizations and to clarify the advisory nature of their role. Reference was made to the arrangements for consultation with non-governmental organizations established by the Economic and Social Council.⁷⁷ While it was stated that such arrangements might be a useful source, it was pointed out that they were not necessarily binding on the Commission as a subsidiary organ of the General Assembly. It was also pointed out that the role of observer States and intergovernmental organizations in the decision-making process would need to be clarified.

240. With respect to the use of languages, general sympathy was expressed for broader use, in addition to English, of French and other official languages of the United Nations, including in documents circulated informally, subject to the availability of resources. As to multilingualism in official documentation, it was recalled that that was an essential characteristic of the work of UNCITRAL as a United Nations body.

241. As to the manner in which the discussion on the working methods should continue, it was agreed that the issue would be placed as a specific item on the agenda of the Commission at its resumed fortieth session (see para. 11 above). Noting that it was highly desirable for the Commission at its resumed fortieth session to finalize, in meetings of a Committee of the Whole, the adoption of the draft Legislative Guide on Secured Transactions, it was considered that the Commission would be able to devote time to the question of working methods at its resumed fortieth session only as far as permitted by the work on the draft Guide. In order to facilitate informal consultations among all interested States, the Secretariat was requested to prepare a report on existing rules and practices (see para. 237 above) and make the necessary arrangements, as resources permitted, for representatives of all interested States to meet on the day prior to the opening of the resumed fortieth session of the Commission and, if possible, during the resumed session.

⁷⁷ Economic and Social Council resolution 1996/31.

B. Internship programme

242. An oral report was presented on the internship programme at the UNCITRAL secretariat. While general appreciation was expressed for the programme, which is designed to give young lawyers the opportunity to become familiar with the work of UNCITRAL and to increase their knowledge of specific areas in the field of international trade law, it was observed that only a small proportion of interns were nationals of developing countries. A suggestion was made that consideration should be given to establishing the financial means of supporting wider participation by young lawyers from developing countries. That suggestion was supported.

C. Evaluation of the role of the Secretariat in facilitating the work of the Commission

243. The Commission was informed that the proposed programme budget for the biennium 2008-2009 listed among the "Expected accomplishments of the Secretariat" its contribution to facilitating the work of UNCITRAL. The performance measure of that expected accomplishment was the satisfaction of UNCITRAL with the services provided, as evidenced by a rating on a scale ranging from 1 to 5 (5 being the highest rating).⁷⁸ The Commission agreed to provide feedback to the Secretariat.

D. Bibliography

244. The Commission had before it a bibliography of recent writings related to its work (A/CN.9/625).

XVIII. Congress 2007

245. The Commission recalled that, at its thirty-eighth and thirty-ninth sessions, in 2005 and 2006, respectively, it had approved a plan, in the context of its fortieth session, to hold a congress similar to the UNCITRAL Congress on Uniform Commercial Law in the Twenty-first Century, held in New York from 18 to 22 May 1992.⁷⁹ The Commission had envisaged that the congress would review the results of the past work programme of UNCITRAL and of related work of other organizations active in the field of international trade law, assess current work programmes and consider and evaluate topics for future work programmes.^{80, 81}

⁷⁸ Proposed programme budget for the biennium 2008-2009, Part III, International justice and law, Section 8, Legal affairs (Programme 6 of the biennial programme plan and priorities for the period 2008-2009), Subprogramme 5, Progressive harmonization, modernization and unification of the law of international trade (A/62/6 (Sect. 8), table 8.19 (d)).

⁷⁹ For the proceedings of the Congress, see *Uniform Commercial Law in the Twenty-first Century: Proceedings of the Congress of the United Nations Commission on International Trade Law, New York, 18-22 May 1992* (A/CN.9/SER.D/1).

⁸⁰ *Official Records of the General Assembly, Sixtieth Session, Supplement No. 17* (A/60/17), para. 231.

⁸¹ *Ibid.*, *Sixty-first Session, Supplement No. 17* (A/61/17), paras. 256-258.

246. At its current session, the Commission noted with appreciation the preparations by the Secretariat for the Congress “Modern Law for Global Commerce”, which was to be held in Vienna after the close of the formal deliberations of the Commission, from 9 to 12 July 2007. The Commission requested the Secretariat to publish the proceedings of the Congress in the official languages of the United Nations to the extent permitted by available resources.

XIX. Date and place of future meetings

A. Dates of the resumed fortieth session

247. The Commission agreed to hold its resumed fortieth session in Vienna from 10 to 14 December 2007 (for the agenda of the resumed fortieth session, see para. 11 above).

B. Forty-first session of the Commission

248. The Commission approved the holding of its forty-first session in New York, from 16 June to 11 July 2008, subject to confirmation or possible shortening of the session, to be decided during its resumed fortieth session, in particular in the light of the progress of work in Working Group II (Arbitration and Conciliation) and Working Group III (Transport Law). (United Nations Headquarters in New York would be closed on Friday, 4 July 2008.)

C. Sessions of working groups up to the forty-first session of the Commission

249. At its thirty-sixth session, in 2003, the Commission agreed that: (a) working groups should normally meet for a one-week session twice a year; (b) extra time, if required, could be allocated from the unused entitlement of another working group provided that such arrangement would not result in an increase of the total number of 12 weeks of conference services per year currently allotted to sessions of all six working groups of the Commission; and (c) if any request by a working group for extra time resulted in an increase in the 12-week allotment, it should be reviewed by the Commission, with proper justification being given by that working group regarding the reasons for which a change in the meeting pattern was needed.⁸²

250. In view of the magnitude and complexities of the project before Working Group III (Transport Law), the Commission decided to authorize two-week sessions of the Working Group to be held in the second half of 2007 and the first half of 2008, utilizing the entitlement of Working Group IV (Electronic Commerce), which would not meet before the forty-first session of the Commission (see paras. 184 above and 251 (c) and (d) below).

251. Subject to possible review at its resumed fortieth session (see para. 11 above), the Commission approved the following schedule of meetings for its working groups:

⁸² Ibid., *Fifty-eighth Session, Supplement No. 17* (A/58/17), para. 275.

(a) Working Group I (Procurement) would hold its twelfth session in Vienna from 3 to 7 September 2007 and its thirteenth session in New York from 7 to 11 April 2008;

(b) Working Group II (Arbitration and Conciliation) would hold its forty-seventh session in Vienna from 10 to 14 September 2007 and its forty-eighth session in New York from 4 to 8 February 2008;

(c) Working Group III (Transport Law) would hold its twentieth session in Vienna from 15 to 25 October 2007 (the United Nations offices in Vienna are closed on 26 October), and its twenty-first session in Vienna from 14 to 25 January 2008, with possible reduction of the duration of the session to one week (see para. 184 above);

(d) No session of Working Group IV (Electronic Commerce) was envisaged;

(e) Working Group V (Insolvency Law) would hold its thirty-third session in Vienna from 5 to 9 November 2007 and its thirty-fourth session in New York from 3 to 7 March 2008;

(f) Working Group VI (Security Interests) would hold its thirteenth session in New York from 19 to 23 May 2008.

D. Sessions of working groups in 2008 after the forty-first session of the Commission

252. The Commission noted that tentative arrangements had been made for working group meetings in 2008 after its forty-first session (the arrangements were subject to the approval of the Commission at its forty-first session):

(a) Working Group I (Procurement) would hold its fourteenth session in Vienna from 8 to 12 September 2008;

(b) Working Group II (Arbitration and Conciliation) would hold its forty-ninth session in Vienna from 15 to 19 September 2008;

(c) Working Group III (Transport Law) would hold its twenty-second session in Vienna from 20 to 24 October 2008;

(d) Working Group IV (Electronic Commerce) would hold its forty-fifth session in Vienna from 27 to 31 October 2008;

(e) Working Group V (Insolvency Law) would hold its thirty-fifth session in Vienna from 17 to 21 November 2008;

(f) Working Group VI (Security Interests) would hold its fourteenth session in Vienna from 24 to 28 November 2008.

Annex

List of documents before the Commission at its fortieth session

<i>Symbol</i>	<i>Title or description</i>
A/CN.9/613	Provisional agenda, annotations thereto and scheduling of meetings of the fortieth session
A/CN.9/614	Report of Working Group II (Arbitration and Conciliation) on the work of its forty-fifth session (Vienna, 11-15 September 2006)
A/CN.9/615	Report of Working Group I (Procurement) on the work of its tenth session (Vienna, 25-29 September 2006)
A/CN.9/616	Report of Working Group III (Transport Law) on the work of its eighteenth session (Vienna, 6-17 November 2006)
A/CN.9/617	Report of Working Group VI (Security Interests) on the work of its eleventh session (Vienna, 4-8 December 2006)
A/CN.9/618	Report of Working Group V (Insolvency Law) on the work of its thirty-first session (Vienna, 11-15 December 2006)
A/CN.9/619	Report of Working Group II (Arbitration and Conciliation) on the work of its forty-sixth session (New York, 5-9 February 2007)
A/CN.9/620	Report of Working Group VI (Security Interests) on the work of its twelfth session (New York, 12-16 February 2007)
A/CN.9/621	Report of Working Group III (Transport Law) on the work of its nineteenth session (New York, 16-27 April 2007)
A/CN.9/622	Report of Working Group V (Insolvency Law) on the work of its thirty-second session (New York, 14-18 May 2007)
A/CN.9/623	Report of Working Group I (Procurement) on the work of its eleventh session (New York, 21-25 May 2007)
A/CN.9/624 and Add.1 and 2	Note by the Secretariat on indicators of commercial fraud
A/CN.9/625	Bibliography of recent writings related to the work of UNCITRAL
A/CN.9/626	Note by the Secretariat on the status of conventions and model laws
A/CN.9/627	Note by the Secretariat on technical cooperation and assistance
A/CN.9/628 and Add.1	Note by the Secretariat on current activities of international organizations related to the harmonization and unification of international trade law
A/CN.9/629	Note by the Secretariat on facilitation of cooperation, direct communication and coordination in cross-border insolvency proceedings
A/CN.9/630 and Add.1-5	Note by the Secretariat on possible future work on electronic commerce: comprehensive reference document on elements required to establish a favourable legal framework for electronic commerce: sample chapter on international use of electronic authentication and signature methods
A/CN.9/631 and Add.1-11	Note by the Secretariat on security interests: recommendations and commentary of the UNCITRAL draft legislative guide on secured transactions
A/CN.9/632	Note by the Secretariat on possible future work on security rights in intellectual property
A/CN.9/633	Note by the Secretariat transmitting comments of the European Community and its member States on the UNCITRAL draft legislative guide on secured transactions
A/CN.9/634	Note by the Secretariat transmitting the report of the Secretary-General of the Permanent Court of Arbitration on its activities under the UNCITRAL Arbitration Rules since 1976
A/CN.9/635	Note by the Secretariat transmitting observations by France on the working methods of UNCITRAL

**Report of the United Nations Commission on International Trade
Law on its resumed fortieth session
(Vienna, 10-14 December 2007) (A/62/17) (Part II)
[Original: English]**

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I. Introduction

1. The present report of the United Nations Commission on International Trade Law (UNCITRAL) covers the resumed fortieth session of the Commission, held in Vienna from 10 to 14 December 2007.
2. Pursuant to General Assembly resolution 2205 (XXI) of 17 December 1966, this report is submitted to the Assembly and is also submitted for comments to the United Nations Conference on Trade and Development.

II. Organization of the session

A. Opening of the session

3. The resumed fortieth session of the Commission was opened on 10 December 2007.

B. Membership and attendance

4. The General Assembly, in its resolution 2205 (XXI), established the Commission with a membership of 29 States, elected by the Assembly. By its resolution 3108 (XXVIII) of 12 December 1973, the Assembly increased the membership of the Commission from 29 to 36 States. By its resolution 57/20 of 19 November 2002, the Assembly further increased the membership of the Commission from 36 to 60 States. The current members of the Commission, elected on 17 November 2003 and on 22 May 2007, are the following States, whose term of office expires on the last day prior to the beginning of the annual session of the Commission in the year indicated:⁸³ Algeria (2010), Armenia (2013), Australia (2010), Austria (2010), Bahrain (2013), Belarus (2010), Benin (2013), Bolivia (2013), Bulgaria (2013), Cameroon (2013), Canada (2013), Chile (2013), China (2013), Colombia (2010), Czech Republic (2010), Ecuador (2010), Egypt (2013), El Salvador (2013), Fiji (2010), France (2013), Gabon (2010), Germany (2013), Greece (2013), Guatemala (2010), Honduras (2013), India (2010), Iran (Islamic Republic of) (2010), Israel (2010), Italy (2010), Japan (2013), Kenya (2010), Latvia (2013), Lebanon (2010), Madagascar (2010), Malaysia (2013), Malta (2013), Mexico (2013), Mongolia (2010), Morocco (2013), Namibia (2013), Nigeria (2010), Norway (2013), Pakistan (2010), Paraguay (2010), Poland (2010), Republic of Korea (2013), Russian Federation (2013), Senegal (2013), Serbia (2010), Singapore (2013), South Africa (2013), Spain (2010), Sri Lanka (2013), Switzerland (2010), Thailand (2010), Uganda (2010), United Kingdom of Great Britain and Northern Ireland (2013), United States of America (2010), Venezuela (Bolivarian Republic of) (2010) and Zimbabwe (2010).

5. With the exception of Armenia, Bahrain, Benin, China, Colombia, Ecuador, Fiji, Gabon, Honduras, Israel, Kenya, Madagascar, Malta, Mongolia, Morocco, Nigeria and Singapore, all the members of the Commission were represented at the resumed fortieth session.

6. The resumed fortieth session was attended by observers from the following States: Argentina, Belgium, Brazil, Burundi, Croatia, Democratic Republic of the

⁸³ Pursuant to General Assembly resolution 2205 (XXI), the members of the Commission are elected for a term of six years. Of the current membership, 30 were elected by the Assembly at its fifty-eighth session, on 17 November 2003 (decision 58/407), and 30 were elected by the Assembly at its sixty-first session, on 22 May 2007 (decision 61/417). By its resolution 31/99, the Assembly altered the dates of commencement and termination of membership by deciding that members would take office at the beginning of the first day of the regular annual session of the Commission immediately following their election and that their terms of office would expire on the last day prior to the opening of the seventh regular annual session following their election.

Congo, Dominican Republic, Indonesia, Libyan Arab Jamahiriya, Panama, Peru, Philippines, Portugal, Romania, Slovakia, Slovenia, Tunisia, Turkey and Zambia.

7. The resumed fortieth session was also attended by observers from the following organizations:

(a) *United Nations system*: World Bank and International Monetary Fund;

(b) *Intergovernmental organizations*: Commission of the African Union, East African Community, European Community and International Institute for the Unification of Private Law;

(c) *Non-governmental organizations invited by the Commission*: American Bar Association, Association française des entreprises privées, Commercial Finance Association, European Centre for Peace and Development, European Law Students' Association, Forum for International Commercial Arbitration, International Bar Association, International Insolvency Institute, International Swaps and Derivatives Association, International Union of Marine Insurance and Union internationale des avocats.

8. The Commission welcomed the participation of international non-governmental organizations with expertise in the major items on the agenda. Their participation was crucial for the quality of texts formulated by the Commission, and the Commission requested the Secretariat to continue to invite such organizations to its sessions.

C. Election of officers

9. The following officers, elected during the first part of the fortieth session, continued in their offices:

Chairperson: Dobrosav Mitrović (Serbia)

Vice-Chairpersons: Biu Adamu Audu (Nigeria)

Horacio Bazoberry (Bolivia)

Kathryn Sabo (Canada)

10. In the absence of the Chairperson, the Commission, at its 855th meeting, on 10 December 2007, decided that Kathryn Sabo (Canada) would be the acting Chairperson at the resumed fortieth session.

11. At its 859th meeting, on 12 December, the Commission elected M. R. Umarji (India) Rapporteur of its resumed fortieth session.

D. Agenda

12. The agenda of the resumed fortieth session, as adopted by the Commission at its 855th meeting, on 10 December 2007, was as follows:

1. Opening of the resumed fortieth session.
2. Adoption of the agenda.

3. Adoption of a draft UNCITRAL legislative guide on secured transactions and possible future work.
4. Working methods of UNCITRAL.
5. Dates of future meetings.
6. Adoption of the report.

E. Adoption of the report

13. At its 863rd and 864th meetings, on 14 December 2007, the Commission adopted the present report by consensus.

III. Draft UNCITRAL Legislative Guide on Secured Transactions

A. General considerations

14. The Commission had before it a complete set of revised recommendations and revised commentaries on the draft UNCITRAL Legislative Guide on Secured Transactions (A/CN.9/637 and Add.1-8 and A/CN.9/631/Add.1-3) and the reports of Working Group VI (Security Interests) on its eleventh session (A/CN.9/617), held in Vienna from 4 to 8 December 2006, and its twelfth session (A/CN.9/620), held in New York from 12 to 16 February 2007. The Commission expressed its appreciation to the Secretariat for the preparation of an extremely large number of complex documents (about 300 pages) in a short period of time (between the first part of the fortieth session and the resumed fortieth session).

15. The Commission recalled that, during the first part of its fortieth session (A/62/17 (Part I), para. 158), it had adopted recommendation 4, subparagraphs (b) and (c), on the scope of the draft Guide as to intellectual property, securities and financial contracts (A/CN.9/631, chapter II), and recommendations 74-230 (A/CN.9/631, chapters VII-XIV); and had approved the substance of the commentaries to chapters VII-XIV (A/CN.9/631/Add.4-11) and on intellectual property (A/CN.9/631/Add.1) and the substance of the terminology (A/CN.9/631/Add.1, paras. 13-19). The Commission also recalled that, as decided during the first part of its fortieth session (A/62/17 (Part I), para. 159), the following materials would be reviewed by the Commission at its resumed session: recommendations 1-73 (A/CN.9/631, as revised in document A/CN.9/637); the commentaries to chapters I-VI (A/CN.9/631/Add.1-3); recommendations on the extension of a retention-of-title right or a financial lease right to proceeds (non-unitary approach), if necessary; and the commentary on the alternatives to the recommendations on the third-party effectiveness of a retention-of-title right or a financial lease right to proceeds (unitary and non-unitary approaches), if necessary. Moreover, the Commission recalled that the question of whether the terminology and the recommendations of the draft Guide should be reproduced not only at the end of each chapter but also in a separate annex to the draft Guide had been referred to its resumed fortieth session (A/62/17 (Part I), para. 159).

B. Consideration of the draft Guide

1. Introduction, chapter I (Key objectives) and section C of chapter II (Scope of application and other general rules)

16. It was noted that the material in the introduction, in chapter I and in chapter II, section C, of the draft Guide (A/CN.9/631/Add.1) could be revised and reorganized into a new introduction as follows:

(a) Section A (Purpose of the Guide) should include the material contained in document A/CN.9/631/Add.1, paragraphs 1-12;

(b) Section B (Examples of financing practices covered in the Guide) should include the material contained in document A/CN.9/631/Add.1, paragraphs 57-77;

(c) Section C with a new heading (Key objectives and fundamental principles of an effective and efficient secured transactions regime) should include the material contained in document A/CN.9/631/Add.1, paragraphs 20-31, and additional material discussing some fundamental principles of the draft Guide that would link the general key objectives of the draft Guide to the specific recommendations;

(d) A new section D (Implementing a new secured transactions law) should be added to provide guidance to national legislators on the different ways in which the recommendations in the draft Guide could be implemented, taking into account existing legislation, legislative methods and drafting techniques and the need for dissemination of information to all those who would implement the law (judges, arbitrators and practitioners) in order to ensure a cohesive regime;

(e) Section E (Terminology) should include the material contained in document A/CN.9/637, paragraphs 1-6;

(f) Section F (Recommendations) should contain recommendation 1 from chapter I (Key objectives) of document A/CN.9/637, appropriately aligned with section C of the new introduction (see subparagraph (c) above).

17. The Commission considered drafting suggestions on those new sections. With regard to the key objective of balancing the interests of affected persons, it was suggested that the commentary should make an express reference to the efforts of the Commission to harmonize secured transactions and insolvency laws. With regard to the fundamental principle of an integrated and functional approach, it was suggested that, to properly reflect both the unitary and the non-unitary approaches to acquisition financing, the commentary should include a provision that, to the maximum extent possible, all transactions that create a right in all types of asset meant to secure the performance of an obligation (i.e. fulfil security functions) should be considered as security rights and regulated by the same rules or, at least, by the same principles. With regard to the fundamental principle of priority among multiple security rights, it was suggested that the commentary should discuss separately the significance of the availability of multiple security rights and the importance of a clear priority rule governing multiple security rights granted by the same grantor in the same assets. With regard to the fundamental principle of equality of treatment of all creditors that provided credit to enable grantors to acquire tangible assets, it was suggested to remove the earlier reference whereby retention-of-title sellers would be able to benefit from the complete range of rights

given to secured creditors, which in some ways exceeded the rights available to retention-of-title sellers under existing law in most States. There was sufficient support for all those suggestions.

18. With regard to the terminology contained in document A/CN.9/637, the following changes were agreed upon:

(a) In subparagraph (n)(ii), the definition of the term “control” with respect to a right to payment of funds credited to a bank account, the text commencing with the word “evidenced” to the end of the subparagraph should be deleted, and a new definition — of the term “control agreement” — should be added along the following lines: “‘Control agreement’ means an agreement between the depositary bank, the grantor and the secured creditor, evidenced by a signed writing, according to which the depositary bank has agreed to follow instructions from the secured creditor with respect to the payment of funds credited to the bank account without further consent from the grantor;”

(b) The definition of an “issuer” of a negotiable document should be revised to read as follows: “‘Issuer’ of a negotiable document means the person that is obligated to deliver the tangible assets covered by the document under the law governing negotiable documents, whether or not that person has agreed to perform all obligations arising from the document;”

(c) To align it with the note to the definition in document A/CN.9/637, the note following the definition of “Right to receive the proceeds under an independent undertaking” should be revised as follows: “... Thus, what is received upon honour of (i.e. as a result of a complying presentation under) an independent undertaking constitutes the ‘proceeds’ of the right to receive the proceeds under an independent undertaking.”

19. The Secretariat was also requested to consider deleting the subparagraph indications before the definitions, if that would not be inconsistent with the editorial rules of the United Nations.

20. Subject to the above-mentioned changes and any consequential editorial amendments, the Commission: (a) approved the reorganizing of the material in the introduction, chapter I and chapter II, section C, of the draft Guide into a new introduction, as set out in paragraph 16 above; (b) approved the substance of the commentary on the new introduction; (c) adopted recommendation 1; and (d) agreed that the terminology should be included not only in section E of the new introduction but also, together with the recommendations (that would also be reproduced at the end of each chapter), in a separate annex to the draft Guide.

2. Chapter II (Scope of application and other general rules) and chapter III (Basic approaches to security)

(a) Recommendations (A/CN.9/637, recommendations 2-12)

21. With regard to recommendation 3, the Commission noted that the commentary would explain the reasons why recommendations in the draft Guide (with the exception of certain recommendations on enforcement) applied to all assignments of receivables, without transforming outright transfers into security rights.

22. With regard to recommendation 5, it was agreed that reference should also be made to the recommendations dealing with security rights in attachments to

immovable property along the following lines: “The law should not apply to immovable property. However, recommendations 21, 25 (chapter on the creation of a security right), 34, 43, 48 (chapter on the effectiveness of a security right against third parties), 84, 85 (chapter on the priority of a security right), 161, 162 (chapter on the enforcement of a security right), 180 and 192 (chapter on acquisition financing) may affect rights in immovable property.”

23. After discussion, the Commission adopted recommendations 2-12, reordered in accordance with the order of the revised commentary (see para. 24 (d) below).

(b) Commentary (A/CN.9/631/Add.1, paras. 32-56 and 78-141)

24. It was noted that the material in chapters II and III of the draft Guide contained in document A/CN.9/631/Add.1 could be revised and reorganized into a new chapter I (Scope of application and basic approaches to secured transactions) as follows:

(a) Section A (Scope of application) should include the material contained in document A/CN.9/631/Add.1, paragraphs 32-54, appropriately updated to reflect the decisions of the Commission during the first part of its fortieth session (A/62/17 (Part I), para. 158);

(b) Section B (Basic approaches to security) should include the material contained in document A/CN.9/631/Add.1, paragraphs 78-141, appropriately updated to reflect the decisions of the Commission during the first part of its fortieth session (A/62/17 (Part I), para. 158);

(c) Section C (Two key themes common to all chapters of the Guide) should include the material contained in document A/CN.9/631/Add.1, paragraphs 55 and 56, appropriately updated to reflect the decisions of the Commission during the first part of its fortieth session (A/62/17 (Part I), para. 158);

(d) Section D should include recommendations 2-12 from document A/CN.9/637, ordered in accordance with subparagraphs (a)-(c) above.

25. The Commission considered drafting suggestions with regard to those new sections. With regard to new chapter I, section B (Basic approaches to security), it was suggested that the draft Guide should further explain the rationale for all the different approaches taken with respect to security rights and their historical evolution. There was sufficient support for that suggestion. It was also suggested that security rights in payment rights arising under or from a financial contract should be excluded from the draft Guide, whether the financial contract was governed by a netting agreement or not. The Commission recalled that it had already adopted recommendation 4, subparagraph (c), in document A/CN.9/631, excluding only payment rights arising under or from financial contracts governed by netting agreements, during the first part of its fortieth session (in document A/CN.9/637, the issues are addressed in recommendation 4, subparagraphs (c) and (d)) (A/62/17 (Part I), paras. 148-151 and 158).

26. Subject to the above-mentioned changes and any consequential editorial amendments, the Commission approved: (a) the reorganizing of the material in chapters II and III of the draft Guide into a new chapter I, as set out in paragraph 24 above; and (b) the substance of the commentary on the new chapter I.

3. Chapter IV (Creation of a security right (effectiveness as between the parties))**(a) Recommendations (A/CN.9/637, recommendations 13-28)**

27. With regard to recommendation 14, the Commission confirmed that it was necessary that the secured creditor (and not just its representative) be identified in the security agreement, because: (a) the agreement would be the basis for the enforcement of the security right; and (b) no confidentiality concerns arose as, unlike a notice, the agreement would not be publicly available. It was also agreed that recommendation 14 would need to include language along the lines of recommendation 57, subparagraph (d), in order to provide a basis for the inclusion in the registered notice of the maximum amount for which the security right might be enforced. In that connection, it was agreed that the commentary should explain that the requirement for a maximum amount could be satisfied even if it was mentioned in a series of documents that referred to each other rather than in a single document.

28. With regard to recommendation 15, it was agreed that the text should be revised to provide that writing was sufficient by itself or in conjunction with a course of conduct.

29. Subject to the changes mentioned above, the Commission adopted recommendations 13-28.

(b) Commentary (A/CN.9/631/Add.1, paras. 142-247)

30. The Commission approved the substance of the commentary to chapter IV subject to the following changes and any consequential editorial amendments:

(a) Paragraph 167 should explain that, if the grantor relinquished possession of an encumbered asset and a written agreement did not already exist, a written agreement would be necessary for a security right to continue to exist after the grantor relinquished possession of the asset;

(b) Paragraphs 174-176 should be revised to provide a more balanced presentation of the two approaches with respect to a maximum amount to be set out in the security agreement and to separate that issue from the issue of security rights securing future obligations;

(c) Paragraph 182, fourth sentence, should be modified along the following lines: "Subject to rules ..., ... the agreement must identify that asset as the grantor's right as a lessee under the lease;"

(d) Paragraph 184, second sentence, should be modified to clearly identify future assets as assets acquired by the grantor or coming into existence after the conclusion of the security agreement, while referring to the creation of a security right rather than to a disposition;

(e) Paragraph 190, last sentence, should refer to assets in general and not just to inventory;

(f) Paragraph 196 should be revised to indicate that a floating charge was indeed a security right (and accordingly the words "so called" and "merely" should be deleted) and should briefly discuss the difference between a floating charge and a fixed charge;

(g) Paragraphs 191-199 should refer to limitations with respect to security rights in all assets based on consumer-protection law or, alternatively, that discussion should be merged with the discussion on identification of assets;

(h) Paragraph 222 should elaborate on the limitation of a security right in tangible assets to the value of those assets before they were commingled in a mass or processed into a product;

(i) Paragraphs 229-232 should explain the reasons why anti-assignment clauses were invalidated with respect to the assignment of certain types of receivables but not with respect to the assignment of other types of receivables;

(j) Paragraph 247, second sentence, should be revised along the following lines: “As a result, ... , provided that the security right in the document is created while the goods are covered by the document of title.”

4. Chapter V (Effectiveness of a security right against third parties)

(a) Recommendations (A/CN.9/637, recommendations 29-53)

31. With regard to recommendation 40, it was agreed that, to align it with the formulation of recommendation 45, the text should be revised along the following lines:

“The law should provide that, if the proceeds are not described in the registered notice as provided by recommendation 39 and do not consist of money, receivables, negotiable instruments or rights to payment of funds credited to a bank account, the security right in the proceeds continues to be effective against third parties for [a short period of time to be specified] days after the proceeds arise. If the security right in such proceeds is made effective against third parties by one of the methods referred to in recommendation 32 or 34 before the expiry of that time period, the security right in the proceeds continues to be effective against third parties thereafter.”

32. Subject to the above-mentioned change, the Commission adopted recommendations 29-53.

(b) Commentary (A/CN.9/631/Add.2)

33. The Commission approved the substance of the commentary to chapter V subject to the following changes and any consequential editorial amendments:

(a) Paragraph 17 should discuss “specialized control” as a concept existing in some jurisdictions only;

(b) Paragraph 20 should further explain that the approach addressed was the approach recommended in the draft Guide;

(c) Paragraph 42 should explain that the approach, under which judgement creditors were given a kind of a property right in an encumbered asset, should be compatible with insolvency law;

(d) Paragraphs 95-98 should clearly state that the issue was a change in the location of the asset or the grantor where that was the connecting factor for the application of the conflict-of-law rules;

(e) Paragraph 115 should refer to “some States” rather than to “other States” and should discuss the various approaches in a balanced way.

5. Chapter VI (The registry system)

(a) Recommendations (A/CN.9/637, recommendations 54-72)

34. With regard to recommendation 54, subparagraph (h), and recommendations 57-59, it was agreed that reference to the term “identifier” should be made in a consistent way.

35. In response to a question, it was noted that recommendation 57 required only the information necessary for third parties in order: (a) to avoid unnecessary information that could confuse third parties or lead to errors that might invalidate notices; (b) to standardize the information required; and (c) to send the message that, unlike immovable property title registries, movable property security right registries required minimal information.

36. The Commission considered the following new recommendations in document A/CN.9/637 (contained in the note after recommendation 57):

“X. The law should provide that an error in the identifier or address of the secured creditor or its representative does not render a registered notice ineffective as long as it has not seriously misled a reasonable searcher.

“Y. The law should provide that an error in the description of certain encumbered assets does not render a registered notice ineffective with respect to other assets sufficiently described.

“Z. The law should provide that an error in the information provided in the notice with respect to the duration of registration and the maximum amount secured, if applicable, does not render a registered notice ineffective.”

37. It was noted that the suggested new recommendations were intended to deal with errors with respect to information in the notice other than the grantor’s identifier (which was dealt with in recommendation 58).

38. While some doubt was initially expressed as to whether those recommendations were necessary, the Commission decided after discussion that they should be retained, as they struck an appropriate balance between the interests of registrants and the interests of searchers by preserving the effectiveness of a registered notice in cases in which a reasonable searcher would not be seriously misled by an erroneous statement in the notice.

39. However, several suggestions were made as to the formulation of the suggested new recommendations. One suggestion was that recommendation X should be recast in a positive way to provide that a notice containing an incorrect statement of the identifier or the address of the secured creditor or its representative would not be ineffective unless it would seriously mislead a reasonable searcher. Another suggestion was that the same rule should apply to notices with erroneous descriptions of the encumbered assets, a matter addressed in recommendation Y. Another suggestion was that recommendation Y could refer to descriptions of encumbered assets that did not meet the requirements of recommendation 63. Another suggestion was that recommendation Z should include a provision whereby protection would be afforded to third parties that suffered damage after reasonably

relying on notices with an erroneous statement of the maximum amount of the secured obligation or the duration of the registration. Yet another suggestion was that reference should be made not to “errors” (which included both a subjective and an objective criterion) but to “incorrect statements” (i.e. the factual result of a subjective error) by a registrant.

40. There was sufficient support for all those suggestions. It was agreed that recommendation X could address incorrect statements with respect to the description of the encumbered assets as well, while recommendation Y could be retained as it was, as it addressed a separate matter (i.e. whether an incorrect statement as to the description of certain assets invalidated the notice with respect to other assets covered in the notice although they were sufficiently described).

41. In addition, the suggestion was made that reference should be made to the fact of registration rather than to the registered notice, as the objective of those recommendations was to preserve registration as a mode of achieving third-party effectiveness. That suggestion was opposed on the grounds that registration should be effective, as, in any case, something was registered and the question was whether the particular registered notice was effective.

42. In response to a question, it was noted that the notion of “reasonable searcher” did not mean that, in order to be reasonable, a searcher would have to search for matters outside the registry to determine, for example, whether an error had been made in the notice. In response to another question, it was noted that, if the law prescribed a limited duration of registration (see recommendation 66), an erroneous statement would not affect the duration of the registration to the extent permitted by the law. It was also noted that whether or not the registry would reject an erroneous statement in that regard was a matter of the technical design of the registry that would not affect the duration of registration under the law. In addition, it was noted that, if the law allowed parties to determine the duration of registration (see recommendation 66), erroneous statements of the duration of registration would be corrected by the system, as, if the registrant paid for 5 years but stated 10 years on the notice, the notice would be cancelled after the expiry of 5 years, while, if the registrant paid for 10 years but wrote 5 years on the notice, the registrant could amend the notice at any time (see recommendation 70).

43. With respect to the maximum amount addressed in the suggested new recommendation Z, it was noted that, if the notice referred to a higher amount than the amount mentioned in the security agreement, the registrant could only enforce its security right with priority up to the amount mentioned in the security agreement. It was also noted that, if the notice referred to a lower amount than the amount mentioned in the security agreement, the registrant could enforce its security right against the grantor up to the outstanding amount of the secured obligation, but would have priority over other competing claimants only up to the lower amount mentioned in the notice. That discussion confirmed that a reference should be made to the maximum amount in the security agreement in order for recommendation 57, subparagraph (d), and new recommendation Z to operate (see para. 27 above).

44. With regard to recommendation 61, it was agreed that the words “after the change in the grantor’s identifier but” should be inserted before the words “before registration of the amendment” in subparagraphs (a) and (b).

45. With regard to recommendation 62, it was noted that the main policy consideration at issue was how to balance the rights of two innocent parties subsequent to a transfer of an encumbered asset (i.e. the original secured creditor of the grantor and a subsequent secured creditor of the transferee of the encumbered asset).

46. Diverging views were expressed. One view was that a secured creditor that held a security right in assets of a grantor but that was not aware of the transfer of an encumbered asset by the grantor should be protected in the sense that the third-party effectiveness of its security right should be preserved (even though the security right would extend to the proceeds received by the grantor). It was stated that such an approach would be in line with the general rule in recommendation 31 (Continued third-party effectiveness after a transfer of the encumbered asset) and would provide an appropriate result. It was also observed that, otherwise, a grantor could defeat the right of a secured creditor by transferring an encumbered asset, a result that could discourage the extension of secured credit. In addition, it was said that the secured creditor of the transferee would have to conduct due diligence and clarify the chain of title of the asset in any case, and could thus discover the existence of security rights granted by prior owners of the asset. In that connection, it was mentioned that the general security rights registry was not designed to replace due diligence or confirmation of the chain of title of assets.

47. Another view was that the secured creditor of the transferee of the asset, having searched the registry against the name of the transferee and having found no previously registered security right, should also be protected in the sense that the security right of the secured creditor of the grantor would not be effective as against the secured creditor of the transferee. It was stated that, otherwise, the secured creditor of the transferee could not rely on the registry to ensure its priority, a result that could undermine the reliability of the registry and lead to the transferee being unable to obtain secured credit.

48. Several suggestions were made in an effort to bridge the gap between the above-mentioned views, including the following: (a) imposing on the grantor or the transferee an obligation to inform the secured creditor of the grantor; and (b) providing that the right of the secured creditor of the transferor remained effective against third parties until a short period of time after the secured creditor acquired knowledge or was notified of the transfer, and then only if the secured creditor had registered a notice against the name of the transferee. Those proposals failed to attract sufficient support. It was stated that the breach of the grantor's obligation to inform the secured creditor would simply create another contractual cause of action, which would be of no use to the secured creditor in the case of the grantor's insolvency. It was also observed that requiring knowledge on the part of the secured creditor would inadvertently lead to litigation with respect to matters such as whether the secured creditor had knowledge, what constituted knowledge and when knowledge was acquired. In addition, it was said that requiring that written notice be given to the secured creditor would not assist secured creditors of the transferee, as they would be unaware of that notice.

49. Recognizing that there was no fully satisfactory solution and that the various suggested solutions had both advantages and disadvantages, the Commission decided that recommendation 62 should be revised to state that the law should

address the issue and that the commentary should discuss the various policy options and their advantages and disadvantages.

50. In the discussion of recommendation 62, diverging views were also expressed as to the relationship between recommendations 61 and 62. One view was that those recommendations were closely linked and that, therefore, the same decision should be made for both. It was stated that a change in the name of the grantor was in effect involved also in the case of the transfer of an encumbered asset. Another view was that the issues addressed in those recommendations were slightly different and, therefore, could be addressed differently. It was stated that, while a secured creditor could find out with relative ease a name change of its grantor, that was not the case with a security right granted by a person that acquired the asset from the grantor. After deliberation, it was decided that recommendation 61 should remain unchanged and that the commentary should explain the rationale for the difference in the approaches followed in recommendations 61 and 62.

51. With regard to recommendation 64, it was agreed that the text should be revised to ensure that a notice could be registered before or after the creation of a security right or before or after the conclusion of a security agreement.

52. With regard to recommendation 66, it was agreed that the word “time” in the third sentence should be replaced with the word “duration”.

53. Subject to the changes mentioned above, the Commission adopted recommendations 54-72.

(b) Commentary (A/CN.9/631/Add.3)

54. The Commission approved the substance of the commentary to chapter VI subject to the following changes and any consequential editorial amendments:

(a) The introductory section to the commentary should include a more systematic explanation as to why the Guide contained a separate chapter addressing the registry system, the difference between property and personal rights and why a registry system was an important mechanism to indicate the potential existence of rights in assets;

(b) Paragraph 8 should clarify that it was the very diversity of approaches that had led to the solution of a notice-based general rights registry;

(c) Paragraph 18 should avoid implying that the issue of public access arose only in the context of notice-based registry systems;

(d) Paragraph 22 should make it clear that even in electronic systems equality of access was a point of general concern;

(e) In paragraph 27, the last sentence should be moved to paragraph 28, and the latter paragraph should make it clear that the prohibition against searching against the creditor name was intended to prevent public searching but not searching for internal purposes;

(f) Paragraph 34, in which searching against certain classes of assets is discussed, should be expanded to address the criteria that would need to be satisfied to permit that type of search (for instance, using a unique identifier for the asset concerned, such as a serial number, and restricting searching to high-value assets for which there was a resale market);

(g) Paragraphs 57 and 58 should be revised to ensure a balanced discussion of the advantages and disadvantages of requiring a maximum amount of the secured obligation to be stated in the notice (discussing separately security rights in future obligations);

(h) In paragraph 66 all legal structures under which legal and natural persons could conduct business, including partnerships, should be discussed;

(i) Paragraphs 67-69 should be redrafted in the light of the decisions of the Commission regarding recommendations 61 and 62 (see paras. 44-50 above).

6. Chapter VII (Priority of a security right)

(a) Recommendations (A/CN.9/637, recommendations 73-106)

55. With regard to recommendation 73, it was agreed that the text should be revised to clarify that it did not apply to priority conflicts between secured creditors that took a security right in an asset from different grantors (see also para. 57 (a), below). It was also agreed that the commentary to recommendations 73 and 76 should clarify that a secured creditor that took a security right in an encumbered asset from a buyer of the asset took the asset subject to a security right (that was granted in the asset by the seller of the asset and was effective against third parties) on the basis of the general principle that a person cannot give to another person more rights than it has (*nemo dat quod non habet*).

56. Recalling that it had adopted the recommendations of chapter VII during the first part of its fortieth session (A/62/17 (Part I), para. 158), and subject to the above-mentioned change, the Commission adopted revised recommendations 73-106.

(b) Commentary (A/CN.9/637/Add.1)

57. Recalling that it had approved the substance of the commentary to chapter VII during the first part of its fortieth session (A/62/17 (Part I), para. 158), the Commission approved the substance of the revised commentary subject to the following changes and any consequential editorial amendments:

(a) It should be clarified (in the definitions, in the recommendations and in the commentary) that rules on priority were designed to deal with competing rights of claimants that were granted a right from the same grantor;

(b) Third-party effectiveness issues should be clearly distinguished from priority issues and repetition should be avoided;

(c) With regard to recommendation 79, the commentary should include discussion of a different approach, under which a transferee of an encumbered asset would take the asset free of the security right if the security right secured a credit extended after the expiry of a certain period of time.

7. Chapter VIII (Rights and obligations of the parties to a security agreement)

(a) Recommendations (A/CN.9/637, recommendations 107-113)

58. With regard to recommendation 109 and, by extension, recommendation 69, it was agreed that, to align the text with recommendation 137, recommendations 109 and 69 should refer to the termination of all commitments to extend credit.

Accordingly, it was agreed that recommendation 109 should be revised along the following lines:

“The secured creditor must return an encumbered asset in its possession if, all commitments to extend credit having been terminated, the security right has been extinguished by full payment or otherwise.”

59. Recalling that it had adopted the recommendations of chapter VIII during the first part of its fortieth session (A/62/17 (Part I), para. 158), and subject to the above-mentioned change, the Commission adopted revised recommendations 107-113.

(b) Commentary (A/CN.9/637/Add.2)

60. Recalling that it had approved the substance of the commentary to chapter VIII during the first part of its fortieth session (A/62/17 (Part I), para. 158), the Commission approved the substance of the revised commentary subject to the following change and any consequential editorial amendments: with regard to recommendation 108, the commentary should explain that it applied only to security rights in tangible assets subject to possession, with respect to which the secured creditor in possession should be obliged to preserve both the asset and its value.

8. Chapter IX (Rights and obligations of third-party obligors)

(a) Recommendations (A/CN.9/637, recommendations 114-127)

61. With regard to recommendation 124, subparagraph (b), it was agreed that, to make it clear that reference was made to a security right created by a transferor of an independent undertaking, the text should be revised along the following lines:

“The rights of a transferee of an independent undertaking are not affected by a security right in the right to receive the proceeds under the independent undertaking created by the transferor or any prior transferor.”

62. Recalling that it had adopted the recommendations of chapter IX during the first part of its fortieth session (A/62/17 (Part I), para. 158), and subject to the above-mentioned change, the Commission adopted revised recommendations 114-127.

(b) Commentary (A/CN.9/637/Add.3)

63. Recalling that it had approved the substance of the commentary to chapter IX during the first part of its fortieth session (A/62/17 (Part I), para. 158), the Commission approved the substance of the revised commentary and requested the Secretariat to make any consequential changes to reflect the above-mentioned change in the recommendations.

9. Chapter X (Enforcement of a security right)

(a) Recommendations (A/CN.9/637, recommendations 128-173)

64. Recalling that it had already adopted the recommendations of chapter X during the first part of its fortieth session (A/62/17 (Part I), para. 158), the Commission noted that some changes might be necessary in order to address issues that had arisen during the finalization of the commentaries after the close of the first part of the fortieth session.

65. With regard to recommendation 137, it was agreed that the grantor should be entitled to exercise its right to pay the secured obligation not “until the disposition of the encumbered asset by the secured creditor” but until the earlier of either such disposition or the conclusion of an agreement of the secured creditor to dispose of the encumbered asset. It was also agreed that the same change should be made in recommendation 142.

66. With regard to recommendation 144, subparagraph (c), which addressed the secured creditor’s remedy of obtaining possession of an encumbered asset extrajudicially, the Commission agreed that reference should be made not only to the grantor but also to the person in possession of the asset, as the main purpose of the provision was to permit extrajudicial enforcement but without a breach of the peace or public order.

67. The suggestion was also made that a new subparagraph should be added to recommendation 144 to provide that the requirements of subparagraphs (a), (b) and (c) did not need to be met if the grantor affirmatively consented at the time the secured creditor sought to obtain possession of the encumbered asset extrajudicially. The Commission noted that, under recommendation 130, after default, the grantor and any other person owing performance of the secured obligation were entitled to waive their rights under the provisions on enforcement. It also noted that, if the suggested new subparagraph were added in recommendation 144, it could place in doubt the application of the rule contained in recommendation 130 in the case of other recommendations in which there was no explicit reference to waiver of rights and remedies. For those reasons, the Commission decided that a new subparagraph was not necessary, but that the matter could usefully be discussed in the commentary.

68. With regard to recommendation 148, subparagraph (c), it was agreed that, to ensure consistency with article 16, paragraph 1, of the United Nations Convention on the Assignment of Receivables in International Trade (2001),⁸⁴ the text should be revised to ensure that it was sufficient if the notice to the grantor was in the language of the security agreement. With regard to the notice to other parties, it was widely felt that it should be in a language that was reasonably expected to be understood by its recipients.

69. With regard to recommendation 149, it was agreed that the bracketed text should be replaced with a new asset-specific recommendation along the following lines:

“The law should provide that, in the case of collection or other enforcement of a receivable, negotiable instrument or enforcement of a claim, the enforcing secured creditor must apply the net proceeds of its enforcement (after deducting costs of enforcement) to the secured obligation. The enforcing secured creditor must pay any surplus remaining to the competing claimants that, prior to any distribution of the surplus, notified the enforcing secured creditor of the competing claimant’s claim, to the extent of that claim. The balance remaining, if any, must be remitted to the grantor.”

70. With regard to recommendation 152, it was agreed that the bracketed text should be deleted, because: (a) it was superfluous in the light of recommendations 8

⁸⁴ General Assembly resolution 56/81, annex.

and 130, which provided for party autonomy; and (b) if that text were retained, a similar proviso would need to be added to all recommendations to which party autonomy would apply.

71. With regard to recommendation 156, it was agreed that the commentary should explain that, once the grantor asked the secured creditor to make a proposal, the secured creditor had to notify all the parties listed in recommendation 154, including the grantor, who could object, as the grantor's proposal did not need to be so specific as to make it impossible for the grantor to object to the specific terms of the secured creditor's proposal.

72. The Commission agreed that, to deal with the enforcement of a security right in an attachment to a movable asset, a new recommendation should be added along the following lines:

“The law should provide that a secured creditor with a security right in an attachment to a movable asset is entitled to enforce its security right in the attachment. A creditor with higher priority is entitled to take control of the enforcement process, as provided in recommendation 142. A creditor with lower priority may pay off the obligation secured by the security right of the enforcing secured creditor in the attachment. The enforcing secured creditor is liable for any damage to the movable asset caused by the act of removal other than any diminution in its value attributable solely to the absence of the attachment.”

73. With regard to recommendation 164, subparagraph (a), it was agreed that the text should refer not only to recommendation 128 (which provided the general standard of conduct in the context of enforcement) but also to recommendation 129 (which provided that that standard could not be waived unilaterally or varied by agreement).

74. With regard to recommendation 165, it was agreed that the recommendation should be revised to make it consistent with the definition of “assignment” in the terminology section and should refer to a receivable assigned “otherwise than by an outright transfer” rather than “by way of security”.

75. Recalling that it had adopted the recommendations of chapter X during the first part of its fortieth session (A/62/17 (Part I), para. 158), and subject to the changes mentioned above, the Commission adopted revised recommendations 128-173.

(b) Commentary (A/CN.9/637/Add.4)

76. Recalling that it had approved the substance of the commentary to chapter X during the first part of its fortieth session (A/62/17 (Part I), para. 158), the Commission approved the substance of the revised commentary and requested the Secretariat to make any consequential changes in order to reflect the above-mentioned changes in the recommendations and the decisions taken by the Commission with respect to the commentary in the context of its discussion of the recommendations.

10. Chapter XI (Acquisition financing)**(a) Recommendations (A/CN.9/637, recommendations 174-199)**

77. Recalling that it had already adopted the recommendations of the chapter on acquisition financing rights (which was chapter XII in A/CN.9/631) during the first part of its fortieth session (A/62/17 (Part I), para. 158), the Commission noted that two alternatives were presented in recommendations 176 and 189 to implement the decision taken by the Commission during the first part of its fortieth session (A/62/17 (Part I), para. 63). It was also noted that, unlike alternative A, which drew a distinction between tangible assets other than inventory and inventory and provided different rules for those types of asset, alternative B did not draw such a distinction and provided the same rule for all tangible assets (namely that registration of a notice within a certain period of time after delivery of the tangible assets was sufficient).

78. In addition, the Commission noted a suggestion by the Secretariat that the same approach might be followed with respect to acquisition security rights in proceeds,⁸⁵ with the difference that the right in the proceeds would be a normal security right and not an acquisition security right. Moreover, the Commission noted that recommendations 183 and 198 had been moved from the chapter on the impact of insolvency on a security right to the chapter on acquisition financing to avoid giving the impression that the characterization of acquisition financing transactions as security or ownership devices was a matter of insolvency law, a result that would run counter to the UNCITRAL Legislative Guide on Insolvency Law⁸⁶ (see, for example, footnote 6 to recommendation 35 of that Guide, which is reproduced as footnote 41 of the draft UNCITRAL Legislative Guide on Secured Transactions contained in document A/CN.9/637). It was also noted that a new recommendation should be added to provide that, if a seller failed to register within the prescribed time period a retention-of-title right in a tangible asset that became an attachment to immovable property, it should have a normal security right.⁸⁷ Furthermore, it was noted that the commentary would explain that it flowed from the concept of ownership that the right of a retention-of-title seller would have priority over an acquisition security right granted by the buyer.⁸⁸

79. With regard to recommendation 187, it was agreed that, to align it with recommendation 22, the text should be revised along the following lines:

“The law should provide that a buyer or lessee may create a security right in a tangible asset that is the object of a retention-of-title right or a financial lease right. The maximum amount realizable from the security right is the asset’s value in excess of the amount owing to the seller or financial lessor.”

80. The Commission adopted revised recommendations 174-199 subject to the above-mentioned changes.

⁸⁵ See in A/CN.9/637, the notes in recommendations 182 and 196.

⁸⁶ United Nations publication, Sales No. E.05.V.10.

⁸⁷ See in A/CN.9/637/Add.5, the note in para. 182.

⁸⁸ See in A/CN.9/637/Add.5, the note in para. 178.

(b) Commentary (A/CN.9/637/Add.5)

81. Recalling that it had approved the substance of the commentary to the chapter on acquisition financing rights during the first part of its fortieth session (A/62/17 (Part I), para. 158), the Commission approved the substance of the revised commentary and requested the Secretariat to make any consequential changes to reflect the above-mentioned changes in the recommendations.

11. Chapter XII (Conflict of laws)

(a) Recommendations (A/CN.9/637, recommendations 200-224)

82. With regard to recommendation 202, it was agreed that the commentary should explain that a possible effect of the recommendation might be that lenders could not confidently lend against existing tangible assets without investigating both the history of the location of the assets and whether they constituted assets subject to specialized registration under the law of any State in which they were previously located or whether they might be the subject of a specialized registration in any other State. It was mentioned that the same point applied to title certificates. It was also mentioned that recommendation 202 gave no guidance in cases of assets being registered in specialized registries in more than one State.

83. With regard to recommendation 204, it was agreed that the text should be revised along the following lines:

“The law should provide that a security right in a tangible asset (other than a negotiable instrument or a negotiable document) in transit or to be exported from the State in which it is located at the time of the creation of the security right may be created and made effective against third parties under the law of the State of the location of the asset at the time of creation as provided in recommendation 200 or, provided that the asset reaches the State of its ultimate destination within [a short period of time to be specified] days after the time of creation of the security right, under the law of the State of its ultimate destination.”

84. With regard to recommendation 205, the concern was expressed by some member States that it might not provide an appropriate applicable law rule for a number of important practices, such as receivables arising under or from financial contracts that were not governed by netting agreements (and were not excluded from the scope of the draft Guide), receivables arising from insurance contracts and receivables assigned in the context of securitization transactions. It was stated that recommendation 205 could create problems for those practices, as: (a) the place of the grantor's central administration was not always easy to determine; (b) the grantor could change the place of its central administration; and (c) the debtor of the receivable could not be protected through application of the law of the grantor's location. It was observed that certainty could be achieved through a rule that would provide that the applicable law would be the law governing the receivable, as the parties to that contract would always be familiar with the law governing the receivable (or the contract from which the receivable arose) and that law would meet their expectations. In order to address that concern, several suggestions were made. One suggestion was that recommendation 205 should be revised to provide more flexibility, indicating that there were other possible approaches (by the addition, for example, of the word “ordinarily” after the words “the law should”).

Another suggestion was that the commentary should further explain the merits of an approach based on the law governing the receivable.

85. The concern was also expressed that the interrelationship among recommendations 45, 205 and 217 was not clear. It was stated that, in particular in cases where an assignor made an assignment, changed the place of its central administration and then made another assignment, the draft Guide did not provide a clear solution as to what the law applicable to those assignments would be. It was noted that, under recommendation 217: (a) the creation of the security right (the proprietary effects as between the parties) would be subject to the law of the grantor's central administration at the time of the creation of the security right (so both assignments would be effective as between the parties); and (b) the third-party effectiveness and priority of the security right would be subject to the law of the grantor's central administration at the time the issue arose (which would mean that the law of the new location of the grantor-assignor would govern third-party effectiveness and priority). However, it was also noted that, under recommendation 45, a secured creditor (assignee) that met the requirements for third-party effectiveness in the first location of the grantor (assignor in the case of a receivable) would have a short period of time to make its security right effective against parties under the law of the new location of the grantor in order to maintain its third-party effectiveness and priority (so the first grantor-assignor would be protected). While some doubt was expressed as to whether that analysis provided a fully satisfactory solution to the problem of the change of the grantor's location, it was widely felt that the commentary should include that useful analysis to clarify the interaction among recommendations 45, 205 and 217.

86. Broad support was expressed for further elaboration in the commentary on the approach based on the law governing the receivable (separately from the approach based on the "location" of the receivables (*lex situs*)). It was suggested that a starting point in that direction might be a text along the following lines: "Some States have a conflict-of-laws rule for intangibles that differs from the rule in recommendation 205. Those States contemplate capital market or other transactions and seek perhaps to establish greater certainty by looking not to the law of the grantor's location but rather to the law governing the intangible. The rule that looks to the law governing the intangible has the advantages of avoiding the risk of a subsequent change of location of the grantor and a single, stable conflict-of-laws rule for transactions involving successive assignments of intangibles among assignors located in different countries. It is not as advantageous for financing practices involving the assignment of intangibles in bulk, as those practices may be governed by laws of multiple countries. Moreover, it shifts the risk of a change of location of the grantor to the risk of a change in the law governing the intangible." While it was agreed that that text was a good starting point, some concern was expressed for the last two sentences. To address that concern, it was suggested that the last two sentences should be deleted or, at least, replaced with more neutral language. In response, it was noted that, in the conflict-of-laws chapter, the same approach should be followed as in all the chapters of the draft Guide, and thus the commentary of the conflict-of-laws chapter should discuss the various approaches setting out their advantages and disadvantages in a way that would ultimately explain the rationale of the recommendation adopted by the Commission.

87. However, the suggestion to revise recommendation 205 was objected to. It was stated that recommendation 205 had already been adopted by the Commission during the first part of its fortieth session (A/62/17 (Part I), para. 158). It was observed that recommendation 205 was in line with the United Nations Assignment Convention, adopted relatively recently, in 2001, on the basis of a draft convention prepared by UNCITRAL. It was also said that all the arguments mentioned in the discussion of recommendation 205 had been considered at length in the process that had led to the preparation of the United Nations Assignment Convention and had been reconsidered during the preparation of the draft Guide. In addition, it was mentioned that, while the law governing the receivable could apply well to practices that involved one existing receivable, it could not provide certainty in the typical case in receivables financing of present and future receivables assigned in bulk, because, at the time of the assignment, parties could not determine the law applicable to matters such as third-party effectiveness and priority with respect to future receivables. Moreover, it was said that the law governing the receivable could not provide certainty in the case of insolvency of the grantor (assignor), which was the main risk in receivables financing, unless the assignor, the assignee and the debtor were located in the same country. By contrast, it was stated, the law of the grantor's location: (a) could be easily determined in most cases (even if, in some exceptional cases, there could be some doubt as to the location of the central administration of the grantor-assignor); and (b) more importantly, was likely to be the place in which the main insolvency proceeding with respect to the grantor would be opened, thus ensuring that the law governing priority and the law governing the ranking of claims in insolvency proceedings would be the law of one and the same jurisdiction.

88. After discussion, the Commission decided that recommendation 205 should not be reopened, although the commentary could further elaborate on the approach based on the law governing the receivable (as an approach distinct from the *lex situs* approach). It was widely felt that, as was done in all commentaries, the commentary on that issue should discuss the approaches taken in the various legal systems, setting out their advantages and disadvantages in a way that would explain the reasons why, on balance, the Commission recommended the rule contained in recommendation 205. It was agreed that the commentary should explain the interaction among recommendations 45, 205 and 217, in particular with a view to explaining how the problem of a change of the grantor's location would be addressed under the draft Guide.

89. With regard to recommendation 214, subparagraph (a), it was agreed that the reference to the law applicable to the relationship between the issuer of a negotiable document and the holder of a security right in the document should be deleted, in order to avoid any inconsistency with the approaches currently taken in the transport laws of different States and a draft convention on the carriage of goods [wholly or partly] [by sea] being prepared by UNCITRAL.

90. With regard to recommendation 220, it was noted that it had been moved from chapter XIV (on the impact of insolvency on a security right) and had been revised in order to avoid inconsistencies with the UNCITRAL Legislative Guide on Insolvency Law. The latter text, it was noted, addressed the law applicable to the validity and effectiveness of rights and claims in insolvency, and not the law applicable to the general priority or the enforcement of a security right. It was also

noted that the commentary would: (a) explain that the first sentence of the recommendation introduced a conflict-of-laws rule that was both generally acceptable and in line with the UNCITRAL Legislative Guide on Insolvency Law (in that its second sentence preserved the application of the *lex fori concursus*); and (b) would cross-refer to the commentary to chapter XIV addressing the impact of insolvency on a security right.

91. Recalling that it had adopted the recommendations of the chapter on private international law (which was chapter XIII in document A/CN.9/631) during the first part of its fortieth session (A/62/17 (Part I), para. 158), and subject to the changes mentioned above, the Commission adopted revised recommendations 200-224.

(b) Commentary (A/CN.9/637/Add.6)

92. Recalling that it had approved the substance of the commentary to the chapter on private international law during the first part of its fortieth session (A/62/17 (Part I), para. 158), the Commission approved the substance of the revised commentary and requested the Secretariat to make any consequential changes to reflect the above-mentioned changes in the recommendations and the decisions taken by the Commission with respect to the commentary in the context of its discussion of the recommendations.

12. Chapter XIII (Transition)

(a) Recommendations (A/CN.9/637, recommendations 225-231)

93. With regard to recommendation 226, it was agreed that the recommendation should not be changed but that the commentary should explain that a secured creditor that had initiated enforcement proceedings under the law in force before the effective date of the new law should have the option of continuing those proceedings under the old law or abandoning those proceedings and initiating proceedings under the new law.

94. With regard to recommendation 231, it was agreed that the reference to “status” should be changed to “priority status” in order to clarify that recommendation 231 simply explained the meaning of the term “priority status” used in recommendation 230.

95. Recalling that it had adopted the recommendations of the chapter on transition (which was chapter XIV in document A/CN.9/631) during the first part of its fortieth session (A/62/17 (Part I), para. 158), and subject to the changes mentioned above, the Commission adopted revised recommendations 225-231.

(b) Commentary (A/CN.9/637/Add.7)

96. Recalling that it had approved the substance of the commentary to the chapter on transition during the first part of its fortieth session (A/62/17 (Part I), para. 158), the Commission approved the substance of the revised commentary and requested the Secretariat to make any consequential changes to reflect the decisions taken by the Commission with respect to the commentary in the context of its discussion of the recommendations.

13. Chapter XIV (The impact of insolvency on a security right)

(a) Recommendations (A/CN.9/637, recommendations 232-239)

97. Recalling that it had adopted the definitions and recommendations of the chapter on insolvency (which was chapter XI in document A/CN.9/631) during the first part of its fortieth session (A/62/17 (Part I), para. 158), the Commission adopted the revised recommendations 232-239.

(b) Commentary (A/CN.9/637/Add.8)

98. Recalling that it had adopted the commentary to the chapter on insolvency during the first part of its fortieth session (A/62/17 (Part I), para. 158), the Commission approved the substance of the revised commentary to chapter XIV on the impact of insolvency on a security right. It also agreed that the commentary should explain that the term “financial contract” was defined in both the draft UNCITRAL Legislative Guide on Secured Transactions and the UNCITRAL Legislative Guide on Insolvency Law in accordance with article 5, subparagraph (k), of the United Nations Assignment Convention and that the note to the definition of the term in the draft Guide⁸⁹ merely explained the definition.

C. Adoption of the UNCITRAL Legislative Guide on Secured Transactions

99. At the close of its deliberations on the draft Guide, the Commission agreed that the Secretariat should be given a mandate to make the changes approved by the Commission, as well as any consequential editorial amendments, avoiding making changes where it was not clear whether a change was editorial or substantive. The Commission also agreed that the Secretariat should review the entire draft Guide with a view to removing any redundant material.

100. At its 864th meeting, on 14 December 2007, the Commission adopted the following resolution:

The United Nations Commission on International Trade Law,

Recognizing the importance to all countries of efficient secured transactions regimes promoting access to secured credit,

Recognizing also that access to secured credit is likely to assist all countries, in particular developing countries and countries with economies in transition, in their economic development and in fighting poverty,

Noting that increased access to secured credit on the basis of modern and harmonized secured transactions regimes will demonstrably promote the movement of goods and services across national borders,

Noting also that the development of international trade on the basis of equality and mutual benefit is an important element in promoting friendly relations among States,

⁸⁹ See A/CN.9/637, para. 6, note to the definition of “financial contract”.

Noting further the importance of balancing the interests of all stakeholders, including grantors of security rights, secured and unsecured creditors, retention-of-title sellers and financial lessors, privileged creditors and the insolvency representative in the grantor's insolvency,

Taking into account the need for reform in the field of secured transactions laws at both the national and international levels as demonstrated by the numerous national law reform efforts under way and the work of international organizations, such as the Hague Conference on Private International Law, the International Institute for the Unification of Private Law (Unidroit) and the Organization of American States, and of international financial institutions, such as the Asian Development Bank, the European Bank for Reconstruction and Development, the Inter-American Development Bank, the International Monetary Fund and the World Bank,

Expressing its appreciation to international intergovernmental and non-governmental organizations active in the field of secured transactions law reform for their participation in and support for the development of the draft UNCITRAL Legislative Guide on Secured Transactions,

Expressing also its appreciation to Kathryn Sabo, Chairperson of Working Group VI (Security Interests) and the acting Chairperson at the resumed fortieth session of the Commission, as well as to the Secretariat, for their special contribution to the development of the draft UNCITRAL Legislative Guide on Secured Transactions,

Noting with satisfaction that the draft UNCITRAL Legislative Guide on Secured Transactions is consistent with the UNCITRAL Legislative Guide on Insolvency Law with regard to the treatment of security rights in insolvency proceedings,

1. *Adopts* the UNCITRAL Legislative Guide on Secured Transactions, consisting of the text contained in documents A/CN.9/631/Add.1-3 and A/CN.9/637 and Add.1-8, with the amendments adopted by the Commission at its fortieth session, and authorizes the Secretariat to edit and finalize the text of the Guide pursuant to the deliberations of the Commission at that session;

2. *Requests* the Secretary-General to disseminate broadly the text of the UNCITRAL Legislative Guide on Secured Transactions, transmitting it to Governments and other interested bodies, such as national and international financial institutions and chambers of commerce;

3. *Recommends* that all States utilize the UNCITRAL Legislative Guide on Secured Transactions to assess the economic efficiency of their secured transactions regimes and give favourable consideration to the Guide when revising or adopting legislation relevant to secured transactions, and invites States that have used the Guide to advise the Commission accordingly.

IV. Working methods of UNCITRAL

101. The Commission recalled that, during the first part of its fortieth session, it had had before it observations and proposals made by France on the working methods of the Commission (A/CN.9/635) and had engaged in a preliminary exchange of views on those observations and proposals. The Commission also

recalled that, at that session, it had been agreed that the issue of working methods would be placed as a specific item on the agenda of the Commission at its resumed fortieth session (A/62/17 (Part I), para. 11). The Commission further recalled that, in order to facilitate informal consultations among all interested States, the Secretariat had been requested to prepare a compilation of procedural rules and practices established by UNCITRAL or by the General Assembly in its resolutions regarding the work of the Commission. It was further recalled that the Secretariat had been requested to make the necessary arrangements, as resources permitted, for representatives of all interested States to meet on the day prior to the opening of the resumed fortieth session of the Commission and, if possible, during the resumed session (A/62/17 (Part I), paras. 234-241).

102. At its resumed session, the Commission had before it, in addition to the observations and proposals made by France on the working methods of the Commission (A/CN.9/635), observations made by the United States of America on the same topic (A/CN.9/639) and, as requested, a note by the Secretariat on the rules of procedure and methods of work of the Commission (A/CN.9/638 and Add.1-6). The Commission noted that, in accordance with its request made during the first part of its fortieth session (see para. 101 above), the Secretariat had made arrangements for representatives of all interested States to meet prior to the opening of the resumed fortieth session in order to hold informal consultations on the rules of procedure and methods of work of the Commission. It was reported that the informal consultations were held among all interested States on 7 December 2007.

103. It was recalled that the Commission, during the first part of its fortieth session, had decided to engage in a comprehensive review of its rules of procedure and methods of work (A/62/17 (Part I), para. 236), and that the General Assembly, in its resolution 62/64 of 6 December 2007, had welcomed that decision. Delegations welcomed the opportunity to review the rules of procedure and methods of work of the Commission and expressed appreciation for the documents submitted to facilitate such a review.

104. Several speakers expressed the view that the elaboration of new rules of procedure for UNCITRAL would not be necessary and that the Commission should continue applying the relevant rules of procedure of the General Assembly with the necessary flexibility, as dictated by the specific nature of the work of the Commission. They pointed out in this regard that the existing flexible approach to the application and interpretation of the relevant rules had proved its effectiveness and contributed to the productivity and success of the Commission. Nevertheless, support was expressed for introducing more clarity in respect of the few issues where uncertainty might exist as to which rules of procedure and methods of work were applicable or where such rules might be applied diversely by the subsidiary organs of the Commission. The competence of the Commission to determine its rules of procedures and methods of work was acknowledged. However, the Commission was urged to exercise utmost caution before entering areas, such as a possible definition of consensus, where its decisions might impact other bodies of the General Assembly.

105. Some speakers expressed the view that it would be premature to decide that the Commission did not need any specific rules of procedure or to make any conclusion as to the form in which future work on the topic might be undertaken, for example through guidelines for chairmen and other officers of working groups

or a manual compiling best practices. It was concluded that only at the end of the review of its rules of procedure and working methods would the Commission be able to decide on its future course of action on the topic.

106. The point was made that, in the course of that review, the Commission should continue reflecting on practical ways to facilitate the participation of representatives of developing countries and non-governmental organizations from those countries in the work of UNCITRAL, including in any preparatory work, in order to ensure that the legislation and practices of these countries were adequately taken into account.

107. The Commission agreed that: (a) any future review should be based on the previous deliberations on the subject in the Commission, the observations made by France (A/CN.9/635) and the United States (A/CN.9/639) and the note by the Secretariat (A/CN.9/638 and Add.1-6), which was considered to provide a particularly important historical overview of the establishment and evolution of UNCITRAL rules of procedure and methods of work; (b) the Secretariat should be entrusted with the preparation of a working document describing current practices of the Commission with the application of rules of procedure and methods of work, in particular as regards decision-making and the participation of non-State entities in the work of UNCITRAL, distilling the relevant information from its previous note (A/CN.9/638 and Add.1-6); the working document would serve as a basis for future formal and informal deliberations of the Commission on the matter, it being understood that, where appropriate, the Secretariat should indicate its observations on rules of procedure and methods of work for consideration by the Commission; (c) the Secretariat should circulate the working document to all States for comment and should compile any comments it might receive; (d) informal consultations among all interested States might be held, if possible, before the forty-first session of the Commission; and (e) the working document might be discussed as early as at the forty-first session of the Commission, time permitting.

V. Dates of future meetings

108. The Commission recalled that, during the first part of its fortieth session (A/62/17 (Part I), para. 248), it had approved the holding of its forty-first session in New York from 16 June to 11 July 2008, subject to confirmation or possible shortening of the session, to be decided during its resumed fortieth session, in particular in the light of the progress of work in Working Group II (Arbitration and Conciliation) and Working Group III (Transport Law). The Commission also recalled that, at that session, it had approved the schedule of meetings for its working groups, subject to possible review at its resumed fortieth session (A/62/17 (Part I), para. 251).

109. At its resumed fortieth session, the Commission decided to shorten the duration of its forty-first session by one week, the new dates of the session thus being from 16 June to 3 July 2008 (United Nations Headquarters in New York would be closed on Friday, 4 July 2008), and to reserve the first nine days of the session, from 16 to 26 June, for the finalization and adoption of a draft convention on the carriage of goods [wholly or partly] [by sea]. The Commission confirmed the schedule of meetings for its working groups approved during the first part of its fortieth session (A/62/17 (Part I), para. 251).

110. It was noted that decisions of the Commission regarding the duration of its sessions were to be made bearing in mind the amount of time needed for the completion of work on its agenda and the fact that lengthy sessions imposed a burden on some States.

VI. Other business

111. The attention of the Commission was brought to General Assembly resolution 62/64 on the report of the United Nations Commission on International Trade Law on the work of its fortieth session, Assembly resolution 62/65 of 6 December 2007 on the fiftieth anniversary of the Convention on the Recognition and Enforcement of Foreign Arbitral Awards, done at New York on 10 June 1958, and Assembly resolution 62/70 of 6 December 2007 on the rule of law at the national and international levels.

112. The Commission took note of the resolutions and deferred their consideration to its forty-first session. The Commission noted that, by paragraph 3 of General Assembly resolution 62/70, the Assembly invited the Commission to comment, in its report to the Assembly, on the current role of the Commission in promoting the rule of law.

113. The Commission decided to include the item “Role of UNCITRAL in promoting the rule of law” in the agenda of its forty-first session and invited all States members of UNCITRAL and observers to exchange their views on the item at that session.

Annex

List of documents before the Commission at its resumed fortieth session

<i>Symbol</i>	<i>Title or description</i>
A/62/17 (Part I)	Report of the United Nations Commission on International Trade Law on the work of its fortieth session (Vienna, 25 June-12 July 2007)
A/CN.9/617	Report of Working Group VI (Security Interests) on the work of its eleventh session (Vienna, 4-8 December 2006)
A/CN.9/620	Report of Working Group VI (Security Interests) on the work of its twelfth session (New York, 12-16 February 2007)
A/CN.9/631/Add.1-3	Note by the Secretariat on the recommendations of the UNCITRAL draft Legislative Guide on Secured Transactions
A/CN.9/635	Note by the Secretariat transmitting observations by France on the working methods of UNCITRAL
A/CN.9/636	Provisional agenda, annotations thereto and scheduling of meetings of the resumed fortieth session
A/CN.9/637	Note by the Secretariat on the terminology and recommendations of the UNCITRAL draft Legislative Guide on Secured Transactions
A/CN.9/637/Add.1-8	Note by the Secretariat on the draft legislative guide on secured transactions
A/CN.9/638 and Add.1-6	Note by the Secretariat on UNCITRAL rules of procedure and methods of work
A/CN.9/639	Note by the Secretariat transmitting observations by the United States on UNCITRAL rules of procedure and methods of work

**B. United Nations Conference on Trade and Development (UNCTAD): extract
from the report of the Trade and Development Board
on its fifty-fourth session
(TD/B/54/8)**

**Progressive development of the law of international trade:
fortieth annual report of the United Nations Commission
on International Trade Law**

At its 1009th plenary meeting, on 3 October 2007, the Board took note of the report of UNCITRAL on its fortieth session (A/62/17).

**C. General Assembly: Report of the Sixth Committee on the
report of the United Nations Commission on International Trade Law
on the work of its fortieth session (A/62/449)**

[Original: English]

Rapporteur: Mr. Adam Mulawarman **Tugio** (Indonesia)

I. Introduction

1. At its 3rd plenary meeting, on 21 September 2007, the General Assembly, on the recommendation of the General Committee, decided to include in the agenda of its sixty-second session the item entitled “Report of the United Nations Commission on International Trade Law on the work of its fortieth session” and to allocate it to the Sixth Committee.
2. The Sixth Committee considered the item at its 11th, 12th and 28th meetings, on 22 and 23 October and 19 November 2007. The views of the representatives who spoke during the Committee’s consideration of the item are reflected in the relevant summary records (A/C.6/62/SR.11, 12 and 28).
3. For its consideration of the item, the Committee had before it the first part of the report of the United Nations Commission on International Trade Law on the work of its fortieth session.¹
4. At the 11th meeting, on 22 October, the Vice-Chairperson of the United Nations Commission on International Trade Law at its fortieth session introduced the first part of the report of the Commission on the work of that session.

II. Consideration of proposals

A. Draft resolution A/C.6/62/L.16

5. At the 28th meeting, on 19 November, the representative of Austria, on behalf of Albania, Algeria, Argentina, Australia, Austria, Azerbaijan, Belarus, Belgium, Brazil, Bulgaria, Cameroon, Chile, China, Colombia, Croatia, Cyprus, the Czech Republic, the Democratic Republic of the Congo, Denmark, Ecuador, El Salvador, Estonia, Ethiopia, Finland, France, Gabon, Germany, Greece, Guatemala, Hungary, Iceland, India, Iran (Islamic Republic of), Ireland, Israel, Italy, Japan, Jordan, Kenya, Latvia, Liechtenstein, Lithuania, Luxembourg, Madagascar, Malaysia, Mexico, Mongolia, Morocco, the Netherlands, Norway, the Philippines, Poland, Portugal, the Republic of Korea, Romania, the Russian Federation, Serbia, Sierra Leone, Singapore, Slovakia, Slovenia, Spain, Sri Lanka, Sweden, Switzerland, Thailand, the former Yugoslav Republic of Macedonia, Trinidad and Tobago, Tunisia, Turkey, Uganda, Ukraine, the United Kingdom of Great Britain and Northern Ireland and Uruguay, subsequently joined by Belize and Burkina Faso, introduced a draft resolution entitled “Report of the United Nations Commission on International Trade Law on the work of its fortieth session” (A/C.6/62/L.16).

¹ *Official Records of the General Assembly, Sixty-second Session, Supplement No. 17 (A/62/17 (Part I)).*

6. At the same meeting, the Committee adopted draft resolution A/C.6/62/L.16 without a vote (see para. 10, draft resolution I).

7. After the adoption of the draft resolution, the representatives of the United States of America, Canada and France made statements in explanation of position (see A/C.6/62/SR.28).

B. Draft resolution A/C.6/62/L.17

8. At the 28th meeting, on 19 November, the representative of Austria, on behalf of the Bureau, introduced a draft resolution entitled “Fiftieth anniversary of the Convention on the Recognition and Enforcement of Foreign Arbitral Awards, done at New York on 10 June 1958” (A/C.6/62/L.17).

9. At the same meeting, the Committee adopted draft resolution A/C.6/62/L.17 without a vote (see para. 10, draft resolution II).

III. Recommendations of the Sixth Committee

10. The Sixth Committee recommends to the General Assembly the adoption of the following draft resolutions:

Draft resolution I

Report of the United Nations Commission on International Trade Law on the work of its fortieth session

The General Assembly,

Recalling its resolution 2205 (XXI) of 17 December 1966, by which it established the United Nations Commission on International Trade Law with a mandate to further the progressive harmonization and unification of the law of international trade and in that respect to bear in mind the interests of all peoples, in particular those of developing countries, in the extensive development of international trade,

Reaffirming its belief that the progressive modernization and harmonization of international trade law, in reducing or removing legal obstacles to the flow of international trade, especially those affecting the developing countries, would contribute significantly to universal economic cooperation among all States on a basis of equality, equity, common interest and respect for the rule of law, to the elimination of discrimination in international trade and, thereby, to peace, stability and the well-being of all peoples,

Having considered the report of the Commission on the work of the first part of its fortieth session,¹

Reiterating its concern that activities undertaken by other bodies in the field of international trade law without adequate coordination with the Commission might lead to undesirable duplication of efforts and would not be in keeping with the aim of promoting efficiency, consistency and coherence in the unification and harmonization of international trade law,

Reaffirming the mandate of the Commission, as the core legal body within the United Nations system in the field of international trade law, to coordinate legal activities in this field, in particular to avoid duplication of efforts, including among organizations formulating rules of international trade, and to promote efficiency, consistency and coherence in the modernization and harmonization of international trade law, and to continue, through its secretariat, to maintain close cooperation with other international organs and organizations, including regional organizations, active in the field of international trade law,

1. *Takes note with appreciation* of the report of the United Nations Commission on International Trade Law on the work of the first part of its fortieth session;¹

2. *Commends* the Commission for its work on the preparation of a legislative guide on secured transactions, which has been designed to facilitate secured financing, thus promoting increased access to low-cost credit and enhancing

¹ A/62/17 (Part I). For the final text, see *Official Records of the General Assembly, Sixty-second Session, Supplement No. 17*.

national and international trade, and notes with satisfaction that the Commission expects to complete that work in the nearest future;

3. *Welcomes* the progress made by the Commission in its work on a revision of its Model Law on Procurement of Goods, Construction and Services² and of the Arbitration Rules of the United Nations Commission on International Trade Law,³ and on the preparation of a draft instrument on transport law and on future developments in insolvency law, and endorses the decision of the Commission to undertake further work in the area of security interests;

4. *Endorses* the efforts and initiatives of the Commission, as the core legal body within the United Nations system in the field of international trade law, aimed at increasing coordination of and cooperation on legal activities of international and regional organizations active in the field of international trade law, as well as promoting the rule of law at the national and international levels in this field, and in this regard appeals to relevant international and regional organizations to coordinate their legal activities with those of the Commission, to avoid duplication of efforts and to promote efficiency, consistency and coherence in the modernization and harmonization of international trade law;

5. *Reaffirms* the importance, in particular for developing countries, of the work of the Commission concerned with technical assistance and cooperation in the field of international trade law reform and development, and in this connection:

(a) Welcomes the initiatives of the Commission towards expanding, through its secretariat, its technical assistance and cooperation programme, and in that respect, encourages the Secretary-General to seek partnerships with State and non-State actors to increase awareness about the work of the Commission and facilitate the effective implementation of legal standards resulting from its work;

(b) Expresses its appreciation to the Commission for carrying out technical assistance and cooperation activities, including at the country, subregional and regional levels, and for providing assistance with legislative drafting in the field of international trade law;

(c) Expresses its appreciation to the Governments whose contributions enabled the technical assistance and cooperation activities to take place, and appeals to Governments, the relevant bodies of the United Nations system, organizations, institutions and individuals to make voluntary contributions to the United Nations Commission on International Trade Law Trust Fund for Symposia and, where appropriate, to the financing of special projects, and otherwise to assist the secretariat of the Commission in carrying out technical assistance activities, in particular in developing countries;

(d) Reiterates its appeal to the United Nations Development Programme and other bodies responsible for development assistance, such as the World Bank and regional development banks, as well as to Governments in their bilateral aid programmes, to support the technical assistance programme of the Commission and to cooperate and coordinate their activities with those of the Commission, in the light of the relevance and importance of the work and programmes of the Commission for promotion of the rule of law at the national and international levels

² *Official Records of the General Assembly, Forty-ninth Session, Supplement No. 17* and corrigendum (A/49/17 and Corr.1), annex I.

³ United Nations publication, Sales No. E.77.V.6.

and for the implementation of the United Nations development agenda, including the achievement of the Millennium Development Goals;

6. *Takes note with regret* that, since the thirty-sixth session of the Commission, no contributions have been made to the trust fund established to provide travel assistance to developing countries that are members of the Commission, at their request and in consultation with the Secretary-General,⁴ stresses the need for contributions to the trust fund in order to increase expert representation from developing countries at sessions of the Commission and its working groups, necessary to build local expertise and capacities in the field of international trade law in those countries to facilitate the development of international trade and the promotion of foreign investment, and reiterates its appeal to Governments, the relevant bodies of the United Nations system, organizations, institutions and individuals to make voluntary contributions to the trust fund;

7. *Decides*, in order to ensure full participation by all Member States in the sessions of the Commission and its working groups, to continue, in the competent Main Committee during the sixty-second session of the General Assembly, its consideration of granting travel assistance to the least developed countries that are members of the Commission, at their request and in consultation with the Secretary-General;

8. *Welcomes* the decision by the Commission to hold a comprehensive review of its working methods, in particular in the light of the recent increase in membership of the Commission and the number of topics being dealt with by the Commission, which should ensure the high quality of the work of the Commission and international acceptability of its instruments, and in this regard recalls its previous resolutions related to this matter;⁵

9. *Recalls* its resolutions on partnerships between the United Nations and non-State actors, in particular the private sector,⁶ and its resolutions in which it encouraged the Commission to further explore different approaches to the use of partnerships with non-State actors in the implementation of its mandate, in particular in the area of technical assistance, in accordance with the applicable principles and guidelines and in cooperation and coordination with other relevant offices of the Secretariat, including the Global Compact Office;⁷

10. *Reiterates its request* to the Secretary-General, in conformity with the General Assembly resolutions on documentation-related matters,⁸ which, in particular, emphasize that any reduction in the length of documents should not adversely affect either the quality of the presentation or the substance of the documents, to bear in mind the particular characteristics of the mandate and work of the Commission in implementing page limits with respect to the documentation of the Commission;

11. *Requests* the Secretary-General to continue providing summary records of the meetings of the Commission relating to the formulation of normative texts;

⁴ Resolution 48/32, para. 5.

⁵ See in particular resolutions 36/32, 37/106, 38/134, 39/82, 40/71, 41/77, 42/152, 43/166 and 57/20.

⁶ Resolutions 55/215, 56/76, 58/129 and 60/215.

⁷ Resolutions 59/39, 60/20 and 61/32.

⁸ Resolutions 52/214, sect. B, 57/283 B, sect. III, and 58/250, sect. III.

12. *Recalls* its resolution approving the establishment of the *Yearbook of the United Nations Commission on International Trade Law*, with the aim of making the work of the Commission more widely known and readily available,⁹ expresses its concern regarding the timeliness of the publication of the *Yearbook*, and requests the Secretary-General to explore options to facilitate the timely publication of the *Yearbook*;

13. *Stresses* the importance of bringing into effect the conventions emanating from the work of the Commission for the global unification and harmonization of international trade law, and to this end urges States that have not yet done so to consider signing, ratifying or acceding to those conventions;

14. *Welcomes* the preparation of digests of case law relating to the texts of the Commission, such as a digest of case law relating to the United Nations Convention on Contracts for the International Sale of Goods¹⁰ and a digest of case law relating to the Model Law on International Commercial Arbitration of the United Nations Commission on International Trade Law,¹¹ with the aim of assisting in the dissemination of information on those texts and promoting their use, enactment and uniform interpretation;

15. *Notes with satisfaction* that the Congress “Modern Law for Global Commerce”, held in Vienna from 9 to 12 July 2007 in the context of the Commission’s fortieth session, reviewed the results of the past work of the Commission as well as related work of other organizations active in the field of international trade law, assessed current work programmes and considered topics and areas for future work, and, acknowledging the importance of the results of the Congress for the coordination and promotion of activities aimed at the modernization and harmonization of international trade law, requests the Secretary-General to ensure the publication of the proceedings of the Congress to the extent permitted by available resources;

16. *Recalls* its resolutions affirming the importance of high-quality, user-friendly and cost-effective United Nations websites and the need for their multilingual development, maintenance and enrichment,¹² commends the restructured website of the Commission in the six official languages of the United Nations, and welcomes the continuous efforts of the Commission to maintain and improve its website in accordance with the applicable guidelines.

⁹ Resolution 2502 (XXIV), para. 7.

¹⁰ United Nations, *Treaty Series*, vol. 1489, No. 25567.

¹¹ *Official Records of the General Assembly, Fortieth Session, Supplement No. 17 (A/40/17)*, annex I.

¹² Resolutions 52/214, sect. C, para. 3; 55/222, sect. III, para. 12; 56/64 B, sect. X; 57/130 B, sect. X; 58/101 B, sect. V, paras. 61-76; 59/126 B, sect. V, paras. 76-95; 60/109 B, sect. IV, paras. 66-80; and 61/121 B, sect. IV, paras. 65-77.

Draft resolution II
Fiftieth anniversary of the Convention on the Recognition and Enforcement of Foreign Arbitral Awards, done at New York on 10 June 1958

The General Assembly,

Recalling the adoption of the Convention on the Recognition and Enforcement of Foreign Arbitral Awards¹ on 10 June 1958 by the United Nations Conference on International Commercial Arbitration (New York, 20 May to 10 June 1958),²

Noting that one hundred and forty-two States have become parties to the Convention, making it one of the most successful treaties in the area of commercial law,

Recognizing the value of arbitration as a method of settling disputes in international commercial relations, contributing to harmonious commercial relations, stimulating international trade and development and promoting the rule of law at the international and national levels,

Convinced that the Convention, by establishing a fundamental legal framework for the use of arbitration and its effectiveness, has strengthened respect for binding commitments, inspired confidence in the rule of law and ensured fair treatment in the resolution of disputes arising over contractual rights and obligations,

Noting that the Convention has served as a model for subsequent multilateral and bilateral treaties and other international legislative texts on arbitration,

Taking note with appreciation of the work of the United Nations Commission on International Trade Law relating to the promotion of the Convention and its uniform interpretation and effective implementation,

Emphasizing the necessity for further national efforts and enhanced international cooperation to achieve universal adherence to the Convention and its uniform interpretation and effective implementation, with a view to fully realizing the objectives of the Convention,

Expressing its hope that States that are not yet parties to the Convention will soon become parties thereto, which would ensure that the legal certainty afforded by the Convention is universally enjoyed, decreasing the level of risk and transactional costs associated with doing business and thus promoting international trade,

1. *Welcomes* the initiatives being undertaken by various organs and agencies within and outside the United Nations system to organize conferences and other similar events to celebrate the fiftieth anniversary of the Convention on the Recognition and Enforcement of Foreign Arbitral Awards¹ and to provide a forum for an exchange of views on experiences worldwide with the implementation of the Convention;

2. *Encourages* the use of these events for the promotion of wider adherence to the Convention and greater understanding of its provisions and their uniform interpretation and effective implementation;

¹ United Nations, *Treaty Series*, vol. 330, No. 4739.

² E/CONF.26/8/Rev.1.

3. *Invites* all States that have not yet done so to consider becoming parties to the Convention;

4. *Requests* the Secretary-General to increase efforts to promote wider adherence to the Convention and its uniform interpretation and effective implementation.

**D. General Assembly resolutions 62/64, 62/65
and 62/70 of 6 December 2007
Resolutions adopted by the General Assembly on the
report of the Sixth Committee (A/62/449)**

**62/64. Report of the United Nations Commission on International Trade Law
on the work of its fortieth session**

The General Assembly,

Recalling its resolution 2205 (XXI) of 17 December 1966, by which it established the United Nations Commission on International Trade Law with a mandate to further the progressive harmonization and unification of the law of international trade and in that respect to bear in mind the interests of all peoples, in particular those of developing countries, in the extensive development of international trade,

Reaffirming its belief that the progressive modernization and harmonization of international trade law, in reducing or removing legal obstacles to the flow of international trade, especially those affecting the developing countries, would contribute significantly to universal economic cooperation among all States on a basis of equality, equity, common interest and respect for the rule of law, to the elimination of discrimination in international trade and, thereby, to peace, stability and the well-being of all peoples,

Having considered the report of the Commission on the work of the first part of its fortieth session,¹

Reiterating its concern that activities undertaken by other bodies in the field of international trade law without adequate coordination with the Commission might lead to undesirable duplication of efforts and would not be in keeping with the aim of promoting efficiency, consistency and coherence in the unification and harmonization of international trade law,

Reaffirming the mandate of the Commission, as the core legal body within the United Nations system in the field of international trade law, to coordinate legal activities in this field, in particular to avoid duplication of efforts, including among organizations formulating rules of international trade, and to promote efficiency, consistency and coherence in the modernization and harmonization of international trade law, and to continue, through its secretariat, to maintain close cooperation with other international organs and organizations, including regional organizations, active in the field of international trade law,

1. *Takes note with appreciation* of the report of the United Nations Commission on International Trade Law on the work of the first part of its fortieth session;¹

2. *Commends* the Commission for its work on the preparation of a legislative guide on secured transactions, which has been designed to facilitate secured financing, thus promoting increased access to low-cost credit and enhancing national and international trade, and notes with satisfaction that the Commission expects to complete that work in the nearest future;

3. *Welcomes* the progress made by the Commission in its work on a revision of its Model Law on Procurement of Goods, Construction and Services² and of the

¹ A/62/17 (Part I). For the final text, see *Official Records of the General Assembly, Sixty-second Session, Supplement No. 17*.

Arbitration Rules of the United Nations Commission on International Trade Law,³ and on the preparation of a draft instrument on transport law and on future developments in insolvency law, and endorses the decision of the Commission to undertake further work in the area of security interests;

4. *Endorses* the efforts and initiatives of the Commission, as the core legal body within the United Nations system in the field of international trade law, aimed at increasing coordination of and cooperation on legal activities of international and regional organizations active in the field of international trade law, as well as promoting the rule of law at the national and international levels in this field, and in this regard appeals to relevant international and regional organizations to coordinate their legal activities with those of the Commission, to avoid duplication of efforts and to promote efficiency, consistency and coherence in the modernization and harmonization of international trade law;

5. *Reaffirms* the importance, in particular for developing countries, of the work of the Commission concerned with technical assistance and cooperation in the field of international trade law reform and development, and in this connection:

(a) Welcomes the initiatives of the Commission towards expanding, through its secretariat, its technical assistance and cooperation programme, and in that respect, encourages the Secretary-General to seek partnerships with State and non-State actors to increase awareness about the work of the Commission and facilitate the effective implementation of legal standards resulting from its work;

(b) Expresses its appreciation to the Commission for carrying out technical assistance and cooperation activities, including at the country, subregional and regional levels, and for providing assistance with legislative drafting in the field of international trade law;

(c) Expresses its appreciation to the Governments whose contributions enabled the technical assistance and cooperation activities to take place, and appeals to Governments, the relevant bodies of the United Nations system, organizations, institutions and individuals to make voluntary contributions to the United Nations Commission on International Trade Law Trust Fund for Symposia and, where appropriate, to the financing of special projects, and otherwise to assist the secretariat of the Commission in carrying out technical assistance activities, in particular in developing countries;

(d) Reiterates its appeal to the United Nations Development Programme and other bodies responsible for development assistance, such as the World Bank and regional development banks, as well as to Governments in their bilateral aid programmes, to support the technical assistance programme of the Commission and to cooperate and coordinate their activities with those of the Commission, in the light of the relevance and importance of the work and programmes of the Commission for promotion of the rule of law at the national and international levels and for the implementation of the United Nations development agenda, including the achievement of the Millennium Development Goals;

6. *Takes note with regret* that, since the thirty-sixth session of the Commission, no contributions have been made to the trust fund established to provide travel assistance to developing countries that are members of the Commission, at their request and in consultation with the Secretary-General,⁴ stresses the need for contributions to the trust fund in order to increase expert

² *Official Records of the General Assembly, Forty-ninth Session, Supplement No. 17 and corrigendum (A/49/17 and Corr.1), annex I.*

³ United Nations publication, Sales No. E.77.V.6.

⁴ Resolution 48/32, para. 5.

representation from developing countries at sessions of the Commission and its working groups, necessary to build local expertise and capacities in the field of international trade law in those countries to facilitate the development of international trade and the promotion of foreign investment, and reiterates its appeal to Governments, the relevant bodies of the United Nations system, organizations, institutions and individuals to make voluntary contributions to the trust fund;

7. *Decides*, in order to ensure full participation by all Member States in the sessions of the Commission and its working groups, to continue, in the competent Main Committee during the sixty-second session of the General Assembly, its consideration of granting travel assistance to the least developed countries that are members of the Commission, at their request and in consultation with the Secretary-General;

8. *Welcomes* the decision by the Commission to hold a comprehensive review of its working methods, in particular in the light of the recent increase in membership of the Commission and the number of topics being dealt with by the Commission, which should ensure the high quality of the work of the Commission and international acceptability of its instruments, and in this regard recalls its previous resolutions related to this matter;⁵

9. *Recalls* its resolutions on partnerships between the United Nations and non-State actors, in particular the private sector,⁶ and its resolutions in which it encouraged the Commission to further explore different approaches to the use of partnerships with non-State actors in the implementation of its mandate, in particular in the area of technical assistance, in accordance with the applicable principles and guidelines and in cooperation and coordination with other relevant offices of the Secretariat, including the Global Compact Office;⁷

10. *Reiterates its request* to the Secretary-General, in conformity with the General Assembly resolutions on documentation-related matters,⁸ which, in particular, emphasize that any reduction in the length of documents should not adversely affect either the quality of the presentation or the substance of the documents, to bear in mind the particular characteristics of the mandate and work of the Commission in implementing page limits with respect to the documentation of the Commission;

11. *Requests* the Secretary-General to continue providing summary records of the meetings of the Commission relating to the formulation of normative texts;

12. *Recalls* its resolution approving the establishment of the *Yearbook of the United Nations Commission on International Trade Law*, with the aim of making the work of the Commission more widely known and readily available,⁹ expresses its concern regarding the timeliness of the publication of the *Yearbook*, and requests the Secretary-General to explore options to facilitate the timely publication of the *Yearbook*;

13. *Stresses* the importance of bringing into effect the conventions emanating from the work of the Commission for the global unification and harmonization of international trade law, and to this end urges States that have not yet done so to consider signing, ratifying or acceding to those conventions;

⁵ See in particular resolutions 36/32, 37/106, 38/134, 39/82, 40/71, 41/77, 42/152, 43/166 and 57/20.

⁶ Resolutions 55/215, 56/76, 58/129 and 60/215.

⁷ Resolutions 59/39, 60/20 and 61/32.

⁸ Resolutions 52/214, sect. B, 57/283 B, sect. III, and 58/250, sect. III.

⁹ Resolution 2502 (XXIV), para. 7.

14. *Welcomes* the preparation of digests of case law relating to the texts of the Commission, such as a digest of case law relating to the United Nations Convention on Contracts for the International Sale of Goods¹⁰ and a digest of case law relating to the Model Law on International Commercial Arbitration of the United Nations Commission on International Trade Law,¹¹ with the aim of assisting in the dissemination of information on those texts and promoting their use, enactment and uniform interpretation;

15. *Notes with satisfaction* that the Congress “Modern Law for Global Commerce”, held in Vienna from 9 to 12 July 2007 in the context of the Commission’s fortieth session, reviewed the results of the past work of the Commission as well as related work of other organizations active in the field of international trade law, assessed current work programmes and considered topics and areas for future work, and, acknowledging the importance of the results of the Congress for the coordination and promotion of activities aimed at the modernization and harmonization of international trade law, requests the Secretary-General to ensure the publication of the proceedings of the Congress to the extent permitted by available resources;

16. *Recalls* its resolutions affirming the importance of high-quality, user-friendly and cost-effective United Nations websites and the need for their multilingual development, maintenance and enrichment,¹² commends the restructured website of the Commission in the six official languages of the United Nations, and welcomes the continuous efforts of the Commission to maintain and improve its website in accordance with the applicable guidelines.

*62nd plenary meeting
6 December 2007*

¹⁰ United Nations, *Treaty Series*, vol. 1489, No. 25567.

¹¹ *Official Records of the General Assembly, Fortieth Session, Supplement No. 17 (A/40/17)*, annex I.

¹² Resolutions 52/214, sect. C, para. 3; 55/222, sect. III, para. 12; 56/64 B, sect. X; 57/130 B, sect. X; 58/101 B, sect. V, paras. 61-76; 59/126 B, sect. V, paras. 76-95; 60/109 B, sect. IV, paras. 66-80; and 61/121 B, sect. IV, paras. 65-77.

62/65. Fiftieth anniversary of the Convention on the Recognition and Enforcement of Foreign Arbitral Awards, done at New York on 10 June 1958

The General Assembly,

Recalling the adoption of the Convention on the Recognition and Enforcement of Foreign Arbitral Awards¹ on 10 June 1958 by the United Nations Conference on International Commercial Arbitration (New York, 20 May to 10 June 1958),²

Noting that one hundred and forty-two States have become parties to the Convention, making it one of the most successful treaties in the area of commercial law,

Recognizing the value of arbitration as a method of settling disputes in international commercial relations, contributing to harmonious commercial relations, stimulating international trade and development and promoting the rule of law at the international and national levels,

Convinced that the Convention, by establishing a fundamental legal framework for the use of arbitration and its effectiveness, has strengthened respect for binding commitments, inspired confidence in the rule of law and ensured fair treatment in the resolution of disputes arising over contractual rights and obligations,

Noting that the Convention has served as a model for subsequent multilateral and bilateral treaties and other international legislative texts on arbitration,

Taking note with appreciation of the work of the United Nations Commission on International Trade Law relating to the promotion of the Convention and its uniform interpretation and effective implementation,

Emphasizing the necessity for further national efforts and enhanced international cooperation to achieve universal adherence to the Convention and its uniform interpretation and effective implementation, with a view to fully realizing the objectives of the Convention,

Expressing its hope that States that are not yet parties to the Convention will soon become parties thereto, which would ensure that the legal certainty afforded by the Convention is universally enjoyed, decreasing the level of risk and transactional costs associated with doing business and thus promoting international trade,

1. *Welcomes* the initiatives being undertaken by various organs and agencies within and outside the United Nations system to organize conferences and other similar events to celebrate the fiftieth anniversary of the Convention on the Recognition and Enforcement of Foreign Arbitral Awards¹ and to provide a forum for an exchange of views on experiences worldwide with the implementation of the Convention;

2. *Encourages* the use of these events for the promotion of wider adherence to the Convention and greater understanding of its provisions and their uniform interpretation and effective implementation;

3. *Invites* all States that have not yet done so to consider becoming parties to the Convention;

¹ United Nations, *Treaty Series*, vol. 330, No. 4739.

² E/CONF.26/8/Rev.1.

4. *Requests* the Secretary-General to increase efforts to promote wider adherence to the Convention and its uniform interpretation and effective implementation.

*62nd plenary meeting
6 December 2007*

62/70. The rule of law at the national and international levels

The General Assembly,

Recalling its resolution 61/39 of 4 December 2006,

Reaffirming its commitment to the purposes and principles of the Charter of the United Nations and international law, which are indispensable foundations of a more peaceful, prosperous and just world, and reiterating its determination to foster strict respect for them and to establish a just and lasting peace all over the world,

Reaffirming also that human rights, the rule of law and democracy are interlinked and mutually reinforcing and that they belong to the universal and indivisible core values and principles of the United Nations,

Reaffirming further the need for universal adherence to and implementation of the rule of law at both the national and international levels and its solemn commitment to an international order based on the rule of law and international law, which, together with the principles of justice, is essential for peaceful coexistence and cooperation among States,

Convinced that the advancement of the rule of law at the national and international levels is essential for the realization of sustained economic growth, sustainable development, the eradication of poverty and hunger and the protection of all human rights and fundamental freedoms, and acknowledging that collective security depends on effective cooperation, in accordance with the Charter and international law, against transnational threats,

Reaffirming the duty of all States to refrain in their international relations from the threat or use of force in any manner inconsistent with the purposes and principles of the United Nations and to settle their international disputes by peaceful means in such a manner that international peace and security, and justice, are not endangered, in accordance with Chapter VI of the Charter, and calling upon States that have not yet done so to consider accepting the jurisdiction of the International Court of Justice in accordance with its Statute,

Convinced that the promotion of and respect for the rule of law at the national and international levels, as well as justice and good governance, should guide the activities of the United Nations and of its Member States,

Recalling paragraph 134 (e) of the 2005 World Summit Outcome,¹

1. *Reiterates its request* to the Secretary-General to prepare an inventory of the current activities of the various organs, bodies, offices, departments, funds and programmes within the United Nations system devoted to the promotion of the rule of law at the national and international levels for submission at its sixty-third session, and welcomes the interim report thereon submitted to the General Assembly at the sixty-second session;²

2. *Also reiterates its request* to the Secretary-General to prepare and submit, after having sought the views of Member States, at its sixty-third session, a report identifying ways and means for strengthening and coordinating the activities listed in the inventory to be prepared pursuant to paragraph 1 above, with special regard to the effectiveness of assistance that may be requested by States in building capacity for the promotion of the rule of law at the national and international levels;

3. *Invites* the International Court of Justice, the United Nations Commission on International Trade Law and the International Law Commission to comment, in

¹ See resolution 60/1.

² A/62/261.

their respective reports to the General Assembly, on their current roles in promoting the rule of law;

4. *Notes with appreciation* the report of the Secretary-General entitled “Uniting our strengths: enhancing United Nations support for the rule of law”³ supports the Rule of Law Coordination and Resource Group, supported by the rule of law unit in the Executive Office of the Secretary-General, under the leadership of the Deputy Secretary-General, and requests the Secretary-General to provide details on the staffing and other requirements for the unit without delay to the General Assembly for its consideration during the sixty-second session in accordance with existing relevant procedures;

5. *Decides* to include in the provisional agenda of its sixty-third session the item entitled “The rule of law at the national and international levels”.

*62nd plenary meeting
6 December 2007*

³ A/61/636-S/2006/980 and Corr.1.

Part Two

STUDIES AND REPORTS ON
SPECIFIC SUBJECTS

I. SECURITY INTERESTS

A. Report of the Working Group on Security Interests on the work of its eleventh session (Vienna, 4-8 December 2006)

(A/CN.9/617) [Original: English]

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I. Introduction

1. At its eleventh session, Working Group VI (Security Interests) continued its work on the preparation of a legislative guide on secured transactions pursuant to a decision taken by the Commission on International Trade Law (UNCITRAL) at its thirty-fourth session, in 2001.¹ The Commission's decision to undertake work in the area of secured credit law was taken in response to the need for an efficient legal regime that would remove legal obstacles to secured credit and could thus have a beneficial impact on the availability and cost of credit.²

II. Organization of the session

2. The Working Group, which was composed of all States members of the Commission, held its eleventh session in Vienna from 4 to 8 December 2006. The session was attended by representatives of the following States members of the Working Group: Algeria, Argentina, Australia, Austria, Belgium, Canada, China, Colombia, Czech Republic, France, Germany, Guatemala, India, Iran (Islamic Republic of), Italy, Japan, Jordan, Mexico, Nigeria, Pakistan, Paraguay, Poland, Qatar, Republic of Korea, Russian Federation, Spain, Sweden, Switzerland, Thailand, Tunisia, Turkey, Uganda, United Kingdom of Great Britain and Northern Ireland and United States of America.

3. The session was attended by observers from the following States: Congo, Dominican Republic, Indonesia, Ireland, Kuwait, Latvia, Libyan Arab Jamahiriya, Malaysia, Mauritius, Peru, Philippines, Romania and Slovakia.

4. The session was also attended by observers from the following international organizations:

(a) *United Nations system*: International Monetary Fund and World Bank;

(b) *International non-governmental organizations invited by the Commission*: American Bar Association, Center for International Legal Studies, Commercial Finance Association, Forum for International Commercial Arbitration, International Association of Restructuring, Insolvency and Bankruptcy Professionals (INSOL International), International Chamber of Commerce, International Swaps and Derivatives Association, Max Planck Institute for Foreign and Private International

¹ *Official Records of the General Assembly, Fifty-sixth Session, Supplement No. 17* and corrigendum (A/56/17 and Corr.3), para. 358. For a history of the project, see A/CN.9/WG.VI/WP.31. The reports of the first to the tenth sessions of the Working Group are contained in documents A/CN.9/512, A/CN.9/531, A/CN.9/532, A/CN.9/543, A/CN.9/549, A/CN.9/570, A/CN.9/574, A/CN.9/588, A/CN.9/593 and A/CN.9/603. The reports of the first and the second joint sessions of Working Group V (Insolvency Law) and VI (Security Interests) are contained in documents A/CN.9/535 and A/CN.9/550. The consideration of those reports by the Commission is reflected in the *Official Records of the General Assembly, Fifty-seventh Session, Supplement No. 17* (A/57/17), paras. 202-204, *Fifty-eighth Session, Supplement No. 17* (A/58/17), paras. 217-222, *Fifty-ninth Session, Supplement No. 17* (A/59/17), paras. 75-78, *Sixtieth Session, Supplement No. 17* (A/60/17), paras. 186-187, and *Sixty-first Session, Supplement No. 17* (A/61/17), paras. 13-78.

² *Official Records of the General Assembly, Fifty-fifth Session, Supplement No. 17* (A/55/17), para. 455, and *Fifty-sixth Session, Supplement No. 17* and corrigendum (A/56/17 and Corr.3), para. 347.

Law, Moot Alumni Association, European Law Students' Association and Union internationale des avocats.

5. The Working Group elected the following officers:

Chairman: Kathryn SABO (Canada)

Rapporteur: Maria Mercedes BUONGERMINI (Paraguay)

6. The Working Group had before it document A/CN.9/WG.VI/WP.29, containing revised recommendations for inclusion in the draft guide.

7. The Working Group adopted the following agenda:

1. Opening of the session and scheduling of meetings.
2. Election of officers.
3. Adoption of the agenda.
4. Preparation of a legislative guide on secured transactions.
5. Other business.
6. Adoption of the report.

III. Deliberations and decisions

8. The Working Group considered recommendations in chapters I (Key objectives of an effective and efficient secured transactions law), II (Scope of application), VI (The registry system), VII (Priority of a security right as against the rights of competing claimants), X (Default and enforcement), XI (Insolvency) and XII (Acquisition financing devices). The deliberations and decisions of the Working Group are set forth below in chapter IV of the present report. The Secretariat was requested to revise the recommendations in the above chapters of the draft guide to reflect the deliberations and decisions of the Working Group.

IV. Preparation of a legislative guide on secured transactions

Chapter I. Key objectives of an effective and efficient secured transactions law

Purpose

9. The Working Group approved the substance of the purpose section unchanged.

Recommendation 1 (key objectives)

10. Subject to clarifying the importance of predictability and transparency of security rights by registration as a separate key objective of the draft guide, the Working Group approved the substance of recommendation 1.

Chapter II. Scope of application

Purpose

11. The Working Group approved the substance of the purpose section unchanged.

Recommendation 2 (assets, parties, secured obligations and security rights)

12. With respect to recommendation 2, paragraph (e), it was agreed that the commentary should explain that regional or international obligations of a State might require that exceptions to the recommendation be made. In particular, it was noted that States members of the European Union might need to exclude transfer of title in financial collateral, such as securities, cash and funds in bank accounts, as under Directive 2002/47/EC of the European Parliament and of the Council of the European Union of 6 June 2002 on financial collateral arrangements, transfer of title had to be recognized according to its terms.

Recommendation 4 (aircraft, railway rolling stock, space objects, ships and intellectual property)

13. With regard to recommendation 4, paragraph (a), it was agreed that it should be revised to reflect the understanding reached with respect to the relationship between the United Nations Convention on the Assignment of Receivables in International Trade (the “United Nations Assignment Convention”) and the Convention on International Interests in Mobile Equipment (Cape Town, 2001). As to recommendation 4, paragraph (b), it was agreed that reference should be made to special laws in general rather than to existing laws only.

Recommendation 5 (securities and immovable property)

14. With respect to recommendation 5, it was agreed that it should be divided into two parts, one dealing with securities and another dealing with immovable property.

15. With respect to securities, the Working Group agreed that the draft guide should cover directly held securities to ensure that the draft guide applied to important financial transactions, such as transactions in which a parent company obtained credit by offering a security right in the shares of its wholly owned subsidiaries. It was also agreed that the exclusion in recommendation 5 should apply to indirectly held securities.

16. As to whether the draft guide should apply to proceeds of directly and indirectly held securities, it was agreed that no additional wording was necessary. It was widely felt that proceeds of directly held securities would be covered in any case, while proceeds of indirectly held securities would be covered only to the extent they were not covered in another international instrument.

17. With respect to immovable property, it was agreed that it should be excluded from the scope of the draft guide, as the law in that regard was well settled and did not lend itself to unification. As to proceeds of immovable property, with respect to whose characterization as immovable or movable property legal systems differed, it was agreed that, if the proceeds took the form of receivables, they could be covered subject to the inclusion of language along the lines of article 4, paragraph 5 (a), of the United Nations Assignment Convention. It was noted that that text was aimed at ensuring that the creation and the priority of a security right under the law governing immovable property would not be affected. As to proceeds of immovable

property other than receivables, it was agreed that they could be covered in the draft guide, if a security right in such proceeds was created by application of the law governing the immovable property or by agreement of the parties.

18. Subject to the changes mentioned above, the Working Group approved the substance of recommendations 2 to 7.

Chapter V. Effectiveness of a security right against third parties

Purpose

19. The Working Group approved the substance of the purpose section unchanged.

Recommendation 39 (lapse in advance registration or third-party effectiveness of a security right)

20. While it was stated that the second sentence of recommendation 39 might be superfluous as it reiterated a priority rule reflected in recommendation 78, it was agreed that recommendation 39 was important and should be retained. However, to clarify the meaning of recommendation 39, it was also agreed that it should be separated into two sections, one referring to third-party effectiveness including registration after creation of a security right and another referring to advance registration (i.e. before creation of a security right).

Recommendation 40 (third-party effectiveness of a security right in tangibles by possession)

21. It was widely felt that, although “possession” was a defined term, recommendation 40 would be easier to understand if it referred to “the transfer of possession to the secured creditor” rather than to third-party effectiveness “through possession”.

22. It was suggested that, to avoid creating the impression that transfer of possession was a condition for the creation of a security right rather than a formal requirement aimed at facilitating the proof of the security agreement (see recommendation 13), either recommendation 34 should refer to transfer of possession as well, or wording along the lines of the language of recommendation 34 should be included in recommendation 40. There was agreement that the proposed text should be included in the commentary. It was widely felt that the statement contained in recommendation 34, which was aimed at clarifying that registration under the regime envisaged in the draft guide was different from other types of registration known to most legal systems (such as registration in immovable property registries), was extremely important and should not be diluted by an additional reference to possession. It was also generally felt that recommendation 13 was sufficient in reflecting the understanding that possession was an element of proof rather than a condition for the creation of a security right.

Recommendation 41 (third-party effectiveness of a non-acquisition security right in low-value consumer goods)

23. Noting that, at the thirty-ninth session of the Commission, broad support had been expressed for the deletion of recommendation 41,³ the Working Group agreed that recommendation 41 should be deleted. It was widely felt that recommendation 41 was not necessary, since there were no financing practices involving non-acquisition security rights in low-value consumer goods and referring to value would create uncertainty as third parties would have to find out the value of the consumer goods to determine whether a notice about a security right in such goods should be registered. The Working Group also agreed that recommendation 35, paragraph (b), which merely referred to recommendation 41, was superfluous and should be deleted as well.

Recommendations 43 and 44 (third-party effectiveness of a security right in proceeds)

24. The view was expressed that alternative A should be retained. It was stated that ensuring that a security right in proceeds became automatically effective against third parties when the proceeds arose without any further act being necessary would promote the overall goal of the draft guide to promote low-cost secured credit. It was also observed that, in any case, well-advised secured creditors would include a generic or specific reference to proceeds in their notices. So, it was pointed out that the main objective of alternative A was to avoid creating a trap for unwary secured creditors.

25. However, the prevailing view was that only alternative B should be retained. It was stated that both alternative A and alternative B were relevant only if the original encumbered assets were described in the notice by reference to a specific category of assets or to a specific asset, as a generic description of the original encumbered assets (e.g. "all assets") would cover all proceeds of any type. It was also observed that, under alternative B, if proceeds were in the form of money and similar assets, the notice would not need to be amended when the proceeds arose. In addition, it was pointed out that the notice would need to be amended only if proceeds took other forms (e.g. of a specific category of assets or a specific asset). Moreover, it was said that, if the grantor wanted to grant a security right in a specific category of assets or in a specific asset, the notice would need to be revised accordingly after the proceeds arose to ensure that the security right would not extend to proceeds other than those described in the notice registered with respect to the original encumbered assets. It was also mentioned that, unlike grantors, which could even be individuals, secured creditors were businesses, which were typically well advised and did not need special protection in that regard.

26. In the discussion, the suggestion was made that alternative A should be retained, while a priority rule could be devised along the lines of alternative B to protect buyers outside the ordinary course of business, as buyers in the ordinary course of business were sufficiently protected by recommendation 82 and subsequent financiers did not need to be protected as, in any case, they would do a search outside the registry to determine which assets were covered by the notice. That suggestion was objected to for the reasons mentioned above (see para. 25).

³ See *Official Records of the General Assembly, Sixty-first Session, Supplement No. 17 (A/61/17)*, para. 25.

27. After discussion, the Working Group decided to delete alternative A and retain alternative B. It was also decided that alternative A should be discussed in the commentary along with the reasoning underlying alternative B. It was also agreed that the brief reference in recommendation 35, paragraph (d), to the rule in recommendations 43 and 44 should be aligned with the revised formulation of those recommendations.

Recommendation 45 (third-party effectiveness of a security right in a right that secures a receivable, negotiable instrument or any other obligation)

28. The concern was expressed that the title and the text of recommendation 45 failed to use neutral language in that it referred to a “security right in a security right”, which was not appropriate in some legal systems, and to its third-party effectiveness. To address that concern, the suggestion was made that recommendation 45 should be revised or deleted. In support of deletion, it was observed that recommendation 24 was sufficient to ensure, for example, that a right securing an assigned receivable would follow the receivable. However, the prevailing view was that recommendation 45 was useful and should be retained, but should be revised to track the language of recommendation 24 referring to the benefits of rights securing an assigned receivable.

Recommendation 54 (third-party effectiveness of a security right in a mass or product)

29. Differing views were expressed as to which alternative would be preferable in recommendation 54. In support of alternative A, it was stated that, unlike proceeds with respect to which the secured creditor retained a security right in the encumbered assets and acquired in addition a security right in another asset as proceeds, in the case of a mass of goods or product, the secured creditor did not acquire a broader right, as provided in recommendation 29. In support of alternative B, it was observed that, as in the case of proceeds, a different asset from the original encumbered asset was involved in situations where goods were commingled in a mass of goods or product (e.g. shoes or handbags were made of leather) and third parties needed to be informed about a security right in that new asset that would be effective against them. However, it was widely felt that there was a difference between proceeds and masses of goods or products, at least to the extent that the resulting product would mostly take the form of inventory and buyers of inventory in the ordinary course of business of the seller were already protected by recommendation 83. It was also generally considered that the objectives of the draft guide would better be served by a simple rule along the lines of alternative A. After discussion, the Working Group decided that alternative A should be retained and alternative B should be deleted.

30. Subject to the changes mentioned above, the Working Group approved the substance of recommendations 30 to 54.

Chapter VI. The registry system

Recommendation 55 (operational framework of the registration and searching process)

31. With respect to recommendation 55, paragraph (c), it was agreed that the commentary could explain that the effectiveness of the registration was not

dependent on who the registrant was but instead on the existence at the time of registration or thereafter of authority to register for which the creation of the security right should be sufficient.

32. With respect to recommendation 55, paragraph (j), it was agreed that it should be revised to provide that, in the case of an electronic registry, operation could be continuous with the exception of scheduled maintenance hours.

Recommendation 56 (security and integrity of the registry)

33. With respect to recommendation 56, paragraph (c), differing views were expressed. One view was that the obligation to send a copy of the notice should be placed on the registry. It was stated that the registry, as a third, neutral party, was better placed to send the notice. It was also observed that any costs ensuing from that obligation would be covered by registration fees paid by registrants but ultimately borne by grantors. In addition, it was said that the registry could not be held liable for any error that was the result of inaccurate information on the notice.

34. The prevailing view, however, was that the secured creditor should be obliged to send a copy of the notice to the grantor. It was stated that the secured creditor was in a better place than the registry to send the notice to the grantor in a time- and cost-efficient way. In addition, it was observed that placing that obligation on the registry could potentially increase not only the operational cost of the registry but also the cost to cover any potential liability of the registry.

35. In the discussion, the question of the legal consequences of failure of the person obligated to send a copy of the notice to the grantor was raised. It was widely felt that such a failure could not affect the effectiveness of the security right or the registration and that any consequences should be limited to nominal penalties.

36. After discussion, it was agreed that the obligation to send a copy of the registered notice to the grantor should be placed on the secured creditor. As to the legal consequences of failure of the secured creditor to meet that obligation, it was agreed that the recommendation should include wording to limit such consequences to nominal penalties and any damages, resulting from the failure of the secured creditor to send the notice, that might be proven.

Recommendation 57 (responsibility for loss or damage)

37. The suggestion was made that responsibility for loss or damage caused by an error of the registry should be limited to malfeasance on the part of registry personnel rather than extend to system malfunction. There was no support for that suggestion.

Recommendation 58 (required content of notice)

38. The Working Group agreed that recommendation 58, paragraph (d), should be retained outside square brackets to permit a State to require that the notice include the maximum amount for which the security right could be enforced if it determined that that was useful for subordinate lending.

Recommendation 62 (change of the grantor's identifier)

39. Support was expressed in favour of all the alternatives in recommendation 62, dealing with a change in the identifier of the grantor. After discussion, the Working

Group decided to retain alternative B giving the secured creditor sufficient time to discover a change in the identifier of the grantor and revise the notice on record. It was stated that the recommendation, as originally formulated, was based on a distinction between assets existing at the time of registration and assets acquired thereafter, which was irrelevant to the need to inform third parties about the change. It was also stated that alternative A might be unworkable as it required the grantor to notify the secured creditor, which would permit the grantor to render a security right ineffective against third parties.

40. At the end of the discussion of recommendation 62, the Secretariat was requested to prepare a new recommendation to address a change of the grantor resulting from a sale of the encumbered assets, a merger, an acquisition or a similar transaction.

Recommendation 64 (time of registration)

41. It was agreed that the commentary could usefully explain that advance registration could take place before any element of creation (i.e. agreement, writing or acquisition of the assets by the grantor) was completed.

Recommendations 68 and 71 (cancellation or amendment of notice)

42. With respect to recommendation 68, it was agreed that the words “by full payment or otherwise” usefully clarified when a security right would be extinguished and should be retained outside square brackets.

43. With regard to recommendation 71, it was agreed that it should be retained outside square brackets to address the question of whether the notice needed to be amended when the secured creditor changed as a result of an assignment of the secured obligation. With respect to the alternatives in the recommendation, it was agreed that the language in the first set of square brackets should be retained to permit an amendment of the notice while, at the same time, ensuring the effectiveness of an unamended notice. It was also agreed that the commentary should explain that third parties relying on the notice should be protected.

44. Subject to the changes mentioned above, the Working Group approved the substance of recommendations 55 to 71.

Chapter VII. Priority of a security right as against the rights of competing claimants

Recommendation 72 (extent of priority)

45. Recalling its decision with respect to recommendation 58, paragraph (d), (see para. 38 above) the Working Group agreed that the language in square brackets, referring to the maximum amount indicated in the notice, should be aligned with the text in recommendation 58, paragraph (d), and retained outside square brackets.

Recommendation 80 (priority of a security right in proceeds)

46. It was agreed that recommendation 80 should list all the exceptions to the rule that the security right in the proceeds had the same priority as the security right in the original encumbered assets.

Recommendations 82 and 83 (rights of buyers, lessees and licensees of encumbered assets)

47. With respect to recommendation 82, it was agreed that subparagraph (a) (ii) should be deleted since the grantor could not grant a security right in an asset that had already been sold to a third party. It was also agreed that subparagraph (b) (ii) could be retained as the grantor could grant a lease or a license in an encumbered asset.

48. With respect to recommendation 83, paragraph (a), it was agreed that buyers of consumer goods should take the goods free of any security right in the goods, as acquisition security rights in consumer goods were not subject to registration (see recommendation 185). It was also agreed that the language in the definition of “buyer in the ordinary course of business” (as well as the other definitions relevant to recommendation 83) should be added to the text of recommendation 83 for the sake of clarity, in particular as the definitions did not form part of the recommendations.

Recommendation 86 (priority of rights of judgement creditors)

49. With respect to the rule in the first sentence of recommendation 86, it was agreed that a security right should have priority over the right of a judgement creditor “unless” the judgement creditor obtained a judgement and took steps to enforce it before the security right was made effective against third parties. As an exception to that rule, it was also agreed that an acquisition security right should have priority over the right of a judgement creditor even if it was made effective after initiation of enforcement proceedings by the judgement creditor but within the grace period provided for in recommendation 184 (see also recommendation 188).

50. With respect to the rule in the second sentence of recommendation 86, differing views were expressed. One view was that that rule should be deleted or clarified to state that a security right should have priority over the right of a judgement creditor as long as credit was extended (i.e. actually paid) or committed (i.e. promised) before the judgement creditor notified the secured creditor. It was stated that the issuance of a judgement against the grantor of a security right at the initiative of an unsecured creditor did not always constitute an event of default permitting the secured creditor to terminate a lending commitment. As a result, a rule along those lines would discourage transactions based on lending commitments, such as a revolving credit facility. It was also observed that, even in cases where issuance of a judgement against the grantor of a security right constituted an event of default which entitled the secured creditor to terminate a lending commitment, the rule would still be inappropriate as it would result in termination of credit, a result that would be contrary to the overall objectives of the draft guide. In addition, it was said that, in some cases, termination of lending commitments was not possible (e.g. in the case of irrevocable letters of credit).

51. Another view was that the rule in the second sentence of recommendation 86 was appropriate and should be retained. It was stated that a security right would have priority if it were made effective against third parties before initiation of enforcement proceedings by an unsecured creditor. It was also observed that a security right would have priority even after initiation of enforcement proceedings up to the time when the judgement creditor notified the secured creditor. In addition, it was said that it was essential that after that time the judgement creditor would know whether there would be any value left in the grantor’s assets for the judgement to be enforced. In order to

achieve that result, it was said, it might suffice to set out and protect types of transaction that involved an irrevocable commitment to lend money.

52. After discussion, the Working Group agreed that the second sentence of recommendation 86 should be revised to reflect both views (see, however, para. 53 below).

53. At the end of its deliberations, the Working Group considered a proposal to ensure that a security right would have priority over the right of a judgement creditor not only with respect to advances but also with respect to irrevocable commitments made before the secured creditor was notified about the judgement. There was broad support for that suggestion. The Secretariat was requested to prepare appropriate wording to reflect that understanding.

Recommendation 87 (priority of rights of persons adding or preserving value of encumbered assets)

54. Differing views were expressed as to whether recommendation 87 should give priority to persons rendering services (e.g. repairers, storers or transporters) with respect to encumbered assets up to the value of the services, up to the value added or preserved as a result of the services rendered or up to the amount of reasonable expenses at the option of the parties. One view was that only claims up to the value added or preserved should be given priority over security rights. It was stated that subordinating a security right to claims of people that did not add to or preserve the value of encumbered assets might create uncertainty that could affect the availability or the cost of credit.

55. The prevailing view, however, was that priority should be given to the rights of persons rendering services with respect to encumbered assets up to the reasonable value of the services. It was stated that that was a limited rule that applied under law other than secured transactions law and only if the person rendering services was in possession of the encumbered assets. It was also observed that the intention of such a rule was to protect non-sophisticated persons that rendered services in the ordinary course of their business and did not have the bargaining power to obtain a security right. In addition, it was said that referring to value added or preserved might inadvertently give rise to a difficult and costly evidentiary burden for such non-sophisticated service providers.

56. After discussion, it was agreed that recommendation 87 should be revised to give priority to claims of service providers up to an amount covering a reasonable value of the services rendered.

Recommendation 92 (priority of a security right in a right to payment of funds credited to a bank account)

57. In response to a question, it was noted that no priority rule was mandatory as recommendation 75 provided that any competing claimant might at any time subordinate its priority unilaterally or by agreement in favour of any other existing or future competing claimant.

58. In response to another question as to whether the draft guide accommodated a system drawing a distinction between a “floating charge” (i.e. a security right in all assets of a grantor) and a “fixed charge” (i.e. a security right in specified assets), it was noted that the draft guide provided for a security right in all assets of a grantor where the grantor could retain possession of the encumbered assets and a licence to

deal with them, but subsumed that right under the general notion of “security right” and did not subordinate it to a security right in specified assets. In that connection, it was stated that it would be for the legislator in each State enacting legislation based on the recommendations of the draft guide to review other bodies of existing domestic law and make any necessary adjustments.

59. In response to yet another question, it was noted that if, by claiming priority under the third sentence of recommendation 92 even over a person with whom the depositary bank had concluded a control agreement, the depositary bank committed a breach of contract, it might be liable to damages under law other than the secured transactions law.

60. After discussion, it was agreed that all those matters should be clarified in the commentary.

Recommendation 95 (priority of a security right in money)

61. It was agreed that the commentary should give examples of transactions in which a security right in money was granted and explain the meaning of the notion of “money” (i.e. notes and coins).

Recommendations 101 and 102 (priority of a security right in attachments to movable property subject to a specialized registration or title certificate system)

62. It was agreed that recommendation 101 could be deleted on the understanding that recommendation 79 would be revised to cover security rights in attachments as well.

63. It was also agreed that recommendation 102 could be retained to cover certain types of attachment to movable property, such as large aircraft engines or parts of motor vehicles, which were subject to separate registration in registries other than the registries in which security rights in the movable property were registrable.

Recommendations 103-105 (priority of a security right in a mass or product)

64. It was agreed that the reference to “the remainder of the aggregate value” in recommendation 104 could be usefully clarified.

65. Subject to the changes mentioned above, the Working Group approved the substance of recommendations 72 to 105.

Chapter X. Default and enforcement

Recommendation 131 (liability)

66. It was agreed that the commentary could explain that recommendation 128 was sufficient to address a waiver or variation of liability of the secured creditor for failure to comply with its obligations under the provisions of the law on default and enforcement, which was the subject of recommendation 131.

Recommendation 136 (summary judicial proceedings)

67. It was agreed that recommendation 136 or the commentary could elaborate on the meaning of summary judicial proceedings by referring to: (a) the need of the

process to be available promptly upon request; (b) notice and opportunity to all interested parties to be heard in accordance with minimum procedural safeguards available in the relevant jurisdiction; and (c) the cost of the proceedings.

Recommendation 140 (court relief)

68. It was widely felt that recommendation 140 could not include a uniform list of measures aimed at deterring unfounded applications to a court or improper interference with the enforcement process because procedures differed from State to State. However, it was agreed that one measure that might be recommended was to shift the burden of paying the costs of the proceedings on the losing party, which could be useful, at least, if the debtor was not insolvent or a solvent third-party guarantor was involved.

Recommendation 142 (secured creditor's right to take possession of an encumbered asset)

69. It was agreed that paragraph (a) of recommendation 142, which was common to both alternative A and alternative B, should be retained. It was widely felt that including in the security agreement a reference to the right of the secured creditor to take possession of the encumbered asset out of court put the grantor on notice at the outset.

70. It was also agreed that paragraph (c) of recommendation 142 should be retained to reflect the rule that out-of-court repossession of the encumbered assets by the secured creditor was permitted only in the absence of any objection by the grantor at that time. It was widely felt that objection would be evident in the case of use or threat of use of force, duress or similar illegal behaviour on the part of the secured creditor. It was also agreed that requiring positive consent could create uncertainty as to the meaning, the time and the scope of such consent.

71. As to paragraph (b) of recommendation 142, differing views were expressed. One view was that alternative A was preferable as it put the grantor on notice without giving the opportunity to a bad faith grantor to conceal the assets or otherwise wrongfully remain in possession of the assets or requiring the secured creditor to describe all the enforcement process at a time when that might not be possible, problems that alternative B was said to raise. Another view was that alternative B was preferable as, by requiring the secured creditor to give a notice of its intention to pursue extrajudicial enforcement with details, it gave the grantor a real opportunity to object, if the grantor so wished.

72. However, it was stated that paragraph (b) did not need to be so broad since: (a) recommendation 141 provided for the right of the secured creditor to take possession of the encumbered asset out of court in the event of default on the part of the grantor; (b) notice of default was sufficient to inform the grantor that it had defaulted; (c) the security agreement was sufficient to put the grantor on notice that the secured creditor had a right to take possession of the encumbered assets out of court; and (d) recommendations 145 and 148 were sufficient to deal with extrajudicial disposition of an encumbered asset and out-of-court acceptance of an encumbered asset by the secured creditor in total or partial satisfaction of the secured obligation. It was also observed that it was important to devise a rule that would encourage grantors to pay rather than use the judicial system to delay enforcement, which was a problem that was generally considered to have a negative impact on the availability and the cost of credit. In addition, it was said that the

typical cases would involve business parties and commercial assets, such as inventory or equipment, rather than automobiles of consumers, with respect to which consumer-protection law would in any case prevail (see recommendation 2, paragraph (b)).

73. In the discussion, the suggestion was made that paragraph (b) of recommendation 142 could include a requirement that the secured creditor inform the grantor of the time it intended to take possession of the encumbered asset out of court. That suggestion was objected to. It was stated that reference to time could create questions, such as whether a notice that failed to mention the time would be effective, what would be the legal consequences of the secured creditor missing the time or what would happen if the grantor requested a change of time.

74. After discussion, it was agreed that paragraph (b) of recommendation 142 should be limited to extrajudicial repossession, focus on the notice of default and the right of the secured creditor to take possession of the encumbered asset out of court under recommendation 141, as well as on the consent of the grantor to out-of-court repossession by the secured creditor given in the security agreement.

Recommendations 144-146 (advance notice of extrajudicial disposition)

75. It was agreed that paragraph (d) of recommendation 145 should be deleted as: (a) recommendation 131 dealt with the liability of the secured creditor for failure to comply with its obligations under the law; (b) recommendation 140 entitled the grantor to obtain judicial relief if a secured creditor pursuing extrajudicial enforcement violated its obligations under the law; and (c) a new recommendation could be included to deal with the consequences of a failure of the secured creditor to comply with its obligations with regard to the rights acquired by a good-faith buyer, lessee or licensee.

76. It was also agreed that recommendation 146 was useful in that it stated the objectives of the notice and the manner in which it should be given and could thus be retained and placed before recommendation 145 or at its beginning.

Recommendations 157 and 158 (rights acquired through extrajudicial disposition)

77. It was agreed that a new recommendation could be included in the draft guide to address the consequences of failure of the secured creditor to comply with any of its obligations under the provisions of the law governing default and enforcement on the rights of a good-faith buyer, lessee or licensee of an encumbered asset.

78. With respect to recommendations 157 and 158, it was agreed that the reference to good faith could be deleted. It was widely felt that, in the case of an extrajudicial sale, lease or licence in compliance with the rules set forth in the law, the question of whether the buyer, lessee or licensee was in good faith would not arise. As to the remedies of the grantor in the case of an extrajudicial sale, lease or licence by the secured creditor not in compliance with the rules of the law to a person in bad faith, it was agreed that that matter could be addressed in recommendation 140.

79. Subject to the changes mentioned above, the Working Group approved the substance of recommendations 126 to 170.

Chapter XI. Insolvency

80. It was noted that the recommendations on insolvency were the result of a significant amount of coordination between Working Group V and Working Group VI and had been approved in principle by the Commission at its thirty-ninth session.⁴ It was stated, however, that some drafting changes might still be needed in the additional insolvency recommendations of the draft guide on valuation of assets and post-commencement financing. It was also observed that some more recommendations from the *UNCITRAL Legislative Guide on Insolvency Law*⁵ might need to be added (e.g. recommendation 63).

81. With respect to recommendation 172, support was expressed for both alternative A and alternative B. With respect to alternative B, it was suggested that some reference should be included to the principle of functional equivalence of secured transactions and retention-of-title devices. It was also suggested that, for reasons of clarity, a recommendation along the lines of alternative A should be added to reflect the unitary approach, which would otherwise be the understanding under the *UNCITRAL Insolvency Guide* (i.e. that references to security right in the *UNCITRAL Insolvency Guide* would apply to retention of title and functionally equivalent devices if a unitary approach were to be followed).

82. After discussion, the Working Group requested the Secretariat to prepare a recommendation along the lines of alternative A to reflect the unitary approach and referred the other suggestions made with respect to recommendation 172 to the Commission. In addition, recalling its decision (see para. 84 below) to refer in the non-unitary approach recommendation to retention of title only and have a separate text for functional equivalents of retention of title, the Working Group agreed that the same approach should be followed in recommendation 172.

Chapter XII. Acquisition financing devices

Terminology

83. The Working Group considered definitions (a) (“security right”) and (b) (“acquisition security right”), as well as the definitions suggested in the note to definition (b) (“acquisition financing devices”, “retention-of-title devices” and “ownership right under a retention-of-title device”).

84. It was noted that, pursuant to consultations between the secretariat of the International Institute for the Unification of Private Law (Unidroit) and the secretariat of the Commission, it was tentatively agreed that, to avoid overlap and conflict between the law recommended in the draft guide and a draft model law on leasing that Unidroit was preparing, that draft model law would defer with respect to leases that created a security right and to the definition of “security right” to the law recommended in the draft guide. However, to implement that approach, it was noted that the Working Group needed to devise a definition of “security right” that would cover both “acquisition security right” (which definition (a) already did) and “retention-of-title ownership (which definition (a) did not currently cover as it was not adjusted to the non-unitary approach developed in the draft guide). In addition, it was noted that financial leases needed to be defined so as to cover those that

⁴ Ibid., para. 62.

⁵ United Nations publication, Sales No. E.05.V.10.

created a security right or the functional equivalent of a security right, but not other leases. After discussion, the Working Group requested the Secretariat to prepare the necessary definitions to ensure effective coordination between the law recommended in the draft guide and the draft model law on leasing being prepared by Unidroit.

85. It was agreed that the definition of “acquisition financing devices” could be retained. With respect to the definitions of “retention-of-title devices” and “ownership under a retention-of-title device”, it was suggested that they should refer only to retention of title, seller and buyer, as, although the same rules should apply to functional equivalents of retention-of-title devices, such as financial leases and purchase-money lending transactions, those latter transactions did not fall terminologically under the notion of “retention-of-title devices”. That suggestion received support subject to ensuring that language would be added in the recommendations on the non-unitary approach to ensure that the recommendations on retention-of-title devices would apply to functionally equivalent transactions, such as financial leases and purchase-money lending transactions.

86. In that connection, it was suggested that the term “financial lease” needed to be defined to ensure that the law recommended in the draft guide would apply to a lease, at the end of the term of which the lessee would retain the asset subject to payment of a price, but not to a lease at the end of the term of which the lessee would return the asset to the lessor. There was support for that suggestion.

87. With respect to the definition of “ownership under a retention-of-title device”, it was also agreed that it should be revised to reflect the conditional character of the sale and the resulting transfer (“until or under the condition that the price is paid”).

88. Subject to the changes mentioned above, the Working Group approved the substance of the definitions of the terms “security right”, “acquisition security right”, “acquisition financing devices”, “retention-of-title devices” and “ownership right under a retention-of-title device”. The Working Group also agreed that text should be added to the recommendations on retention-of-title devices to ensure that they applied to functionally equivalent transactions, such as financial leases and purchase-money transactions. In addition, it was agreed that a definition of the term “financial lease” should also be included in the terminology.

A. Unitary approach to acquisition financing devices

Recommendation 183 (creation of an acquisition security right)

89. It was agreed that the rule applicable to the creation of a non-acquisition security right (i.e. recommendation 13) should also apply to the creation of an acquisition security right and, as a result, recommendation 183 (unitary approach) should be deleted.

Recommendation 185 (exceptions to the requirement of registration with respect to an acquisition security right)

90. It was agreed that the reference to “possession” in the second sentence of recommendation 185, which was intended to ensure that the exception from the registration rule in the first sentence for acquisition security rights in consumer goods did not affect methods of third-party effectiveness other than registration in the general security rights registry, could be deleted. It was widely felt that “possession” would be generally part of creation.

Recommendation 186 (priority of an acquisition security right in goods other than inventory or consumer goods as against an earlier registered non-acquisition security right in the same goods)

91. It was agreed that the priority given by recommendation 186 to an acquisition security right in goods other than inventory or consumer goods should also be given to an acquisition security right in consumer goods. It was widely felt that sales of consumer goods to consumers should be protected. It was stated that the absence of registration would not adversely affect general, non-acquisition financing of consumer goods, as normally the general financier would not extend credit with future consumer goods as security.

Recommendation 192 (priority of an acquisition security right in proceeds of inventory)

92. It was widely felt that the super-priority given under recommendation 187 to acquisition security rights in inventory should not be extended to proceeds of inventory in the form of receivables. It was stated that such an approach would not discourage inventory acquisition financing as, in most jurisdictions, the rights of the inventory acquisition financier were extinguished after the sale of the inventory in the ordinary course of business. It was also observed that failure to exclude receivables from the rule in recommendation 192 would discourage receivables financing as the receivables financier would lose to the inventory financier. After discussion, it was agreed that the words “other than receivables” should be retained outside square brackets in recommendation 192.

B. Non-unitary approach to acquisition financing devices**Purpose**

93. The Working Group postponed consideration of the text in square brackets in paragraph (b) of the purpose section until it had an opportunity to consider recommendation 193 where the issue of compatibility with the regime governing the enforcement of ownership rights arose (see para. 103 below). It was agreed that paragraph (c) of the purpose section should be aligned with paragraph (c) of the purpose section under the unitary approach.

Recommendation 182 (equivalence of an ownership right under a retention-of-title device to a security right)

94. The Working Group postponed consideration of the text in square brackets in recommendation 182 until it had an opportunity to consider recommendation 193 where the issue of compatibility with the regime governing the enforcement of ownership rights arose.

Recommendation 183 (creation of an ownership right under a retention-of-title device)

95. It was agreed that a minimal writing requirement should be adopted, permitting the use of electronic records and any evidence of the intention of the seller to retain title to the goods sold under retention of title. It was also agreed that an additional recommendation should be included to ensure that a buyer that bought goods under retention of title by the seller would be entitled, even before full payment and acquisition of ownership in the goods, to use the value paid for the goods to obtain

credit secured by the goods. It was stated that that was possible even in jurisdictions in which retention-of-title devices were the main forms of non-possessory security under various theories, such as the theory that the buyer had an expectation of ownership.

96. In addition, it was stated that the reference to the creation of ownership rights should be revised as a retention-of-title sale did not actually “create” ownership. It was also observed that a rule of interpretation could be added to ensure that a purchase-money security right could be created and have priority, while making clear that the purchase-money lender would not become the owner. After discussion, the Secretariat was requested to revise the formulation of recommendation 183, as well as any other recommendation that used the same formulation.

Recommendations 185 (exceptions to the requirement of registration with respect to an acquisition security right), 186 (priority of an acquisition security right in goods other than inventory or consumer goods as against an earlier registered non-acquisition security right in the same goods) and 192 (priority of an acquisition security right in proceeds of inventory)

97. It was agreed that the same changes made to recommendations 185, 186 and 192 in the context of the unitary approach should be made to those recommendations in the context of the non-unitary approach.

Recommendation 187 (priority of an ownership right under a retention-of-title device in inventory as against an earlier registered non-acquisition security right in inventory of the same kind)

98. Doubt was expressed as to whether priority was an appropriate concept to use with respect to ownership rights under retention-of-title devices (although it was admitted that priority was an appropriate concept for rights under financial leases and purchase-money lending transactions). However, it was clarified that that put into question neither the usefulness of recommendations 187 and 188 nor the need for registration of a notice about retention-of-title devices and their functional equivalents in the general security rights registry.

99. In that connection, serious concern was expressed as to the requirement to register ownership rights on the grounds that such an approach was contrary to current practice in many jurisdictions. In that connection, it was noted that, at its thirty-ninth session, the Commission had approved the substance of all the recommendations of the draft guide⁶ and thus fundamental policy issues on which the Commission had reached a decision were no longer open for discussion by the Working Group. In any case, it was stated that the draft guide did not require registration of ownership rights but rather a notice informing third parties that the buyer in possession of the goods bought under retention of title might not be the owner. In addition, it was observed that the functional approach (requiring that the same or equivalent rules, including the rules on registration, applied to all devices serving security functions), had been approved both by the Working Group (see A/CN.9/574, para. 46 and A/CN.9/588, para. 52) and the Commission,⁷ as it was essential for a secured transactions regime that would promote the availability of low-cost credit.

⁶ See *Official Records of the General Assembly, Sixty-first Session, Supplement No. 17 (A/61/17)*, paras. 13-78.

⁷ *Ibid.*, para. 18.

100. In the discussion, it was explained that, at least for some of those that expressed concern with regard to registration of retention-of-title rights, there was no fundamental objection to the notion of registration of retention-of-title rights as long as it was made clear that the draft guide did not require registration of ownership but rather of a notice aimed at informing third parties that the buyer might not be the owner of the goods in its possession.

Recommendation 193 (enforcement of an ownership right under a retention-of-title device)

101. It was agreed that both alternative A and alternative B should be retained. It was widely felt that, with respect to the enforcement of ownership rights under retention-of-title devices, the principle of functional equivalence should be followed but only to the extent that it was not incompatible with the regime applicable to the enforcement of ownership rights. It was stated that, to the extent that enforcement of ownership rights differed from State to State, application of the principle embodied in alternative B would result in non-uniform results. In addition, it was agreed that the commentary should explain the application of both alternative A and alternative B.

102. Recalling its decision to postpone consideration of the text in square brackets in paragraph (b) of the purpose section until it had had an opportunity to consider recommendation 193, the Working Group agreed that the bracketed text in paragraph (b) of the purpose section and recommendation 182 could be deleted. It was widely felt that the matter addressed in the bracketed text had been sufficiently dealt with in alternative B of recommendation 193 (non-unitary approach).

103. Also recalling its decision to refer in the non-unitary approach to retention of title, buyers and sellers only (see para. 85 above), the Working Group agreed that appropriate wording should be added to ensure that the non-unitary approach recommendations applied not only to retention of title but also to functionally equivalent devices, such as financial leases (properly defined to cover only those at the end of the term of which the assets would be transferred to the lessee) and other acquisition financing transactions.

104. Subject to the changes mentioned above, the Working Group approved the substance of recommendations 182 to 194 (unitary and non-unitary approach).

V. Future work

105. It was noted that the twelfth session of the Working Group was scheduled to take place in New York from 12 to 16 February 2007 and the fortieth session of the Commission was scheduled to take place in Vienna from 25 June to 12 July 2007. The Working Group also noted that the draft guide was expected to be considered by the Commission from 25 June to 2 July with final adoption expected to take place on 6 July 2007. In addition, the Working Group noted that from 9 to 12 July 2007 a congress on international trade law would take place in the context of the Commission session for delegates and experts to discuss relevant issues for future reference.

**B. Note by the Secretariat on the draft legislative guide on secured transactions:
terminology and recommendations, submitted to the Working Group on Security
Interests at its eleventh session
(A/CN.9/WG.VI/WP.29) [Original: English]**

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Terminology and rules of interpretation¹

1. The present Guide adopts terminology to express the concepts that underlie an effective secured transactions regime. The terms used are not drawn from any particular legal system. Even when a particular term appears to be the same as that found in a particular national law, the meaning given to the term may differ. This approach is taken to provide readers with a common vocabulary and conceptual framework and to encourage harmonization of the law governing security rights.

2. “Or” is not intended to be exclusive; use of the singular also includes the plural and vice versa; “include” and “including” are not intended to indicate an exhaustive list; “may” indicates permission and “should” indicates instruction; and

¹ The definitions and the rules of interpretation are part of the commentary, not of the recommendations of the Guide. They are included in the present document for the Working Group’s ease of reference. They are based on the definitions and rules of interpretation contained in document A/CN.9/WG.VI/WP.27/Add.1, unless otherwise indicated.

“such as” and “for example” are to be interpreted in the same manner as “include” or “including”. [“Creditors” should be interpreted as including both the creditors in the forum State and foreign creditors, unless otherwise specified.] References to “person” should be interpreted as including both natural and legal persons, unless otherwise specified. The term “law” throughout the Guide is intended to include both statutory and non-statutory law. The phrase “law governing negotiable instruments” or any similar expression encompasses all law that applies to negotiable instruments, including not only negotiable instrument law but also contract and other law that might be applicable. The same rule applies to the phrase “law governing negotiable documents”.

3. The following paragraphs identify the principal terms used and the core meaning given to them in the Guide. The meaning of those terms is further refined when they are used in subsequent chapters, which also define and use additional terms (as is the case, for example, with the chapter on insolvency). The definitions should be read together with the relevant recommendations.

(a) “Security right” means a consensual property right in movable property and attachments that secure payment or other performance of one or more obligations, regardless of whether the parties have designated it as a security right. It includes acquisition security rights and non-acquisition security rights. With respect to receivables, security right also means an outright transfer of a receivable, as well as a transfer by way of security. References to a “security right” in the Guide also refer to the “right of an assignee”;

(b) “Acquisition security right” means [, in the context of a unitary approach,] a security right in an asset that secures the obligation to pay any unpaid portion of the purchase price of the asset or an obligation incurred to enable the grantor to acquire the asset. Acquisition security rights include rights, which are denominated as security rights, as well as rights acquired under retention-of-title sales, hire-purchase transactions, financial leases and purchase-money lending transactions. “Grantor” of an acquisition security right includes a buyer, financial lessee or grantor in a purchase-money lending transaction. “Acquisition financier” means the secured creditor with an acquisition security right and includes a retention-of-title seller, financial lessor or purchase-money lender;

[Note to the Working Group: The Working Group may wish to define “acquisition financing devices” along the following lines:

“Acquisition financing devices [in the context of a unitary approach] are arrangements that, whether denominated as security devices or not, enable a person to acquire possession or use of assets subject to an obligation to pay their price to a person that retains a security right in them until the price is paid.”

This definition could be placed right before the definition of “acquisition security right”.

The Working Group may also wish to consider that additional definitions are necessary for the non-unitary approach along the following lines:

(a) “Retention of title devices” [in the context of a non-unitary approach] are arrangements that enable a person to acquire possession or use of assets subject to an obligation to pay their price to a person who retains title in them until the price is paid. Retention-of-title devices [in the context of a non-unitary approach] include

retention-of-title sales, hire-purchase agreements, financial leases and purchase-money lending transactions; and

(b) “Ownership right under a retention of-title device” [in the context of a non-unitary approach] is ownership in an asset that secures the obligation to pay any unpaid portion of the purchase price of the asset or other obligation incurred to enable the buyer, financial lessee or grantor to acquire the asset.” (For this note, see A/CN.9/WG.VI/WP.24/Add.5, note to the definitions).]

(c) “Secured obligation” means the obligation secured by a security right;

(d) “Secured creditor” means a creditor that has a security right. References to the “secured creditor” in the Guide also refer to the “assignee”;

(e) “Debtor” means a person that owes performance of the secured obligation [and includes secondary obligors, such as guarantors of a secured obligation]. The debtor may or may not be the person that grants the security right to a secured creditor (see grantor);

(f) “Grantor” means a person that creates a security right in one or more of its assets in favour of a secured creditor to secure either its own obligation or that of another person (see debtor of the receivable). References to the “grantor” in the Guide also refer to the “assignor”;

[Note to the Working Group: The Working Group may wish to note that the third sentence in the definitions of “security right”, and the second sentence in the definitions of “secured creditor” and “grantor” is intended to ensure that the general recommendations apply to security rights in receivables and to outright transfers of receivables, unless otherwise provided.]

(g) “Security agreement” means an agreement between a grantor and a creditor, in whatever form or terminology, that creates a security right;

(h) “Encumbered asset” means tangible or intangible movable property that is subject to a security right;

(i) “Tangible property” means all forms of corporeal movable property. Among the categories of tangibles are inventory, equipment, attachments, negotiable instruments and negotiable documents;

(j) “Inventory” means a stock of tangibles held for sale or lease in the ordinary course of business and also raw and semi-processed materials (work-in-process);

(k) “Equipment” means tangibles used by a person in the operation of its business;

(l) “Attachments to immovable property” means tangibles that are so physically attached to immovable property as to be treated as immovable property without however losing their identity as movables under the law of the State where the immovable property is located;

[Note to the Working Group: The Working Group may wish to note that the commentary will set forth examples of attachments to immovable property, such as air-conditioning equipment or furnace but not bricks or cement (for this note, see A/CN.9/WG.VI/WP.26/Add.4, definitions).]

(m) “Attachments to movable property” means tangibles that are so physically attached to other movable property [as to be treated as part of that movable property], without however losing their identity under law other than this law;

[Note to the Working Group: The Working Group may wish to note that the commentary will set forth examples of attachments to movable property, such as tires and aircraft engines (for this note, see A/CN.9/WG.VI/WP.26/Add.4, definitions).]

(n) “Mass or product” means tangibles other than money that are so physically associated or united with each other that they lose their separate identity under law other than this law;

(o) “Intangible property” means all forms of movable property other than tangibles. Among the categories of intangibles are receivables and other rights to the performance of non-monetary obligations;

(p) “Receivable” means a right to payment of a monetary obligation and a contractual right to performance of a non-monetary obligation excluding rights to payment evidenced by a negotiable instrument, the obligation to pay under an independent undertaking and the obligation of a bank to pay funds credited to a bank account;

[Note to the Working Group: The Working Group may wish to note that the definition of “receivable” has been revised to reflect the understanding of the Working Group that the general recommendations, as supplemented by the recommendations on receivables, should apply to: (a) contractual non-monetary receivables (see A/CN.9/603, para. 35); and (b) non-contractual receivables (see A/CN.9/603, para. 36). In addition, language has been added in definition (w), “original contract”, to ensure that reference to “original contract” includes any other non-contractual source of a receivable. Moreover, language has been added within square brackets to: (a) recommendation 22 (effectiveness of a bulk assignment and an assignment of future, parts of and undivided interests in receivables) to ensure that statutory limitations on the assignability of non-contractual receivables is not interfered with; and (b) to recommendation 109 (representations of the assignor) to ensure that the recommendations dealing with representations of the assignor do not apply to an assignment of a non-contractual receivable (see A/CN.9/603, para. 36; see also notes to recommendations 2, subparagraph (a), 22 and 109).]

(q) “Assignment” means the creation of a security right in a receivable, including an outright transfer of a receivable;

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that the creation of a security right in a receivable includes an outright transfer of receivables by way of security, which is treated in the Guide as a security right.]

(r) “Assignor” means the person that makes an assignment of a receivable;

(s) “Assignee” means the person to which an assignment of a receivable is made;

(t) “Subsequent assignment” means an assignment by the initial or any other assignee. In the case of a subsequent assignment, the person that makes that

assignment is the assignor and the person to which that assignment is made is the assignee;

(u) “Debtor of the receivable” means a person liable for payment of a receivable. “Debtor of the receivable” includes a guarantor, as an accessory guarantee is a receivable;

[Note to the Working Group: The Working Group may wish to recall that, at its tenth session, it agreed that the word “account” should be deleted from the references to “the account debtor”. The term “account debtor” has been replaced with the term “debtor of the receivable”. Thus, the word “debtor” continues to refer to the debtor of the secured obligation and confusion with that term is avoided. In addition, this approach is consistent with the United Nations Assignment Convention, in which reference is made to “the debtor” to denote “the debtor of the receivable”. The slight difference in the terminology is due to the fact that the Convention uses the term “assignor” to refer to the debtor of the secured obligation.]

(v) “Notice” means a communication in writing [, except where otherwise provided in the Guide]. “Notification of the assignment” means a communication in writing that reasonably identifies the assigned receivable and the assignee. The writing requirement is met by an electronic communication if the information contained therein is accessible so as to be usable for subsequent reference (see article 6 of the UNCITRAL Model Law on Electronic Commerce and article 9 (2) of the Electronic Contracting Convention);

[Note to the Working Group: The Working Group may wish to note that the Guide refers to several types of notice (i.e. notice registered in the general security rights registry, notice of default, notice of intention to pursue extrajudicial enforcement, notification of the assignment and notification of inventory financiers on record). The Working Group may wish to consider whether any of these notices should not be in writing and whether the same term should be used for all notices or a different term should be used for some of them (e.g. “notice” or “registered notice” for the notice registered in the general security rights registry and “notification” for all other notices).

The Working Group may wish to note that the rule that “writing” includes electronic communications is reflected in recommendation 10. Depending on whether the reference to a “signed writing” is retained in recommendations 13 (creation) and 116, subparagraph (c) (agreement not to raise defences of the debtor of the receivable), the Working Group may wish to consider whether the rule contained in recommendation 11 that “signature” includes electronic signature should be reflected in the definitions as well as in recommendation 11.]

(w) “Original contract” in the context of an assignment means the contract between the assignor and the debtor of the receivable from which the receivable arises. With respect to the non-contractual receivables, “original contract” means the non-contractual source of the receivable;

(x) “Negotiable instrument” means an instrument that embodies a right to payment, such as a cheque, bill of exchange or promissory note, which satisfies the requirements for negotiability under the law governing negotiable instruments;

(y) “Negotiable document” means a document that embodies a right for delivery of tangibles, such as a warehouse receipt or a bill of lading, and satisfies the requirements for negotiability under the law governing negotiable documents;

(z) “Independent undertaking” means a letter of credit (commercial or standby), a confirmation of a letter of credit, an independent guarantee (demand, first demand, bank guarantee or counter-guarantee) or any other undertaking recognized as independent by law or practice rules, such as the United Nations Convention on Independent Guarantees and Standby Letters of Credit (“the United Nations Guarantee and Standby Convention”), the Uniform Customs and Practice for Documentary Credits, the International Standby Practices, and the Uniform Rules for Demand Guarantees;

(aa) “Proceeds under an independent undertaking” means the right to receive a payment due, a draft accepted or deferred payment incurred or another item of value, in each case to be delivered by the guarantor/issuer honouring or by a nominated person giving value for a draw under an independent undertaking. The term does not include:

- (i) The right to draw (i.e. to request payment) under an independent undertaking; or
- (ii) What is received under an independent undertaking or upon disposition of proceeds under an independent undertaking (i.e. the proceeds themselves);

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that the definition refers to “proceeds under an independent undertaking” to be consistent with terminology generally used in independent undertaking law and practice. The term as used in the Guide means the right of the grantor as beneficiary of an independent undertaking to receive whatever payment or other value is given under the independent undertaking contingent upon the beneficiary’s compliance with the terms and conditions of the independent undertaking. The term does not include the proceeds themselves, that is, what is actually received upon honour of a drawing from the guarantor/issuer, confirmer or nominated person (a beneficiary’s receipt of value from a negotiating bank should not be characterized as honour or disposition) or upon disposition of a right to proceeds under an independent undertaking.]

The term “proceeds under an independent undertaking” refers to a right to receive even though the term “proceeds” as used in independent undertaking law and practice may refer either to the right to receive or to whatever is received under the independent undertaking and even though the term “proceeds” as used elsewhere in the Guide refers to whatever is received. The commentary will highlight the distinction between a security right in proceeds under an independent undertaking (as an original encumbered asset) and the “proceeds” (a key concept of the Guide) of assets covered in the Guide.]

(bb) “Guarantor/issuer” means a bank or other person that issues an independent undertaking;

(cc) “Confirmer” means a bank or other person that adds its own independent undertaking to that of the guarantor/issuer;

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that, in line with article 6, subparagraph (e), of the United Nations Guarantee and Standby Convention, a confirmation provides the

beneficiary with the option of demanding payment from the confirmer in conformity with the terms and conditions of the confirmed independent undertaking instead of from the guarantor/issuer.]

(dd) “Nominated person” means a bank or other person that is identified in an independent undertaking by name or type (e.g. “any bank in country X”) as being nominated to give value under an independent undertaking and that acts pursuant to that nomination;

(ee) A secured creditor has “control” [as against a guarantor/issuer, confirmer or nominated person] with respect to proceeds under an independent undertaking:

- (i) Automatically upon the creation of the security right if the guarantor/issuer, confirmer or nominated person is the secured creditor; or
- (ii) If the guarantor/issuer, confirmer or nominated person has made an acknowledgment in favour of the secured creditor.

[Note to the Working Group: The Working Group may wish to refer with respect to the bracketed text to the note to recommendation 96 (priority of a security right in proceeds under an independent undertaking).]

(ff) “Acknowledgment” with respect to proceeds under an independent undertaking means that the guarantor/issuer, confirmer or nominated person that will pay or otherwise give value upon a draw under an independent undertaking has, unilaterally or by agreement:

- (i) Acknowledged or consented to (however acknowledgement or consent is evidenced) the creation of a security right (whether denominated as an assignment or otherwise) in favour of the secured creditor in the proceeds from an independent undertaking; or
- (ii) Has obligated itself to pay or give value to the secured creditor upon a draw under an independent undertaking.

(gg) “Bank account” means an account that is maintained by a bank into which funds may be deposited or credited. The term includes a checking or other current account, as well as a savings or time deposit account. The term does not include a claim against the bank arising under law governing negotiable instruments;

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that the right to payment of funds credited to a bank account covers a right to the payment of funds transferred into an internal account of the bank and not applied to any obligations owing to the bank. The commentary will also explain that funds transferred to the bank by way of anticipated reimbursement of a future payment obligation that the bank has accepted in the ordinary course of its banking business is also covered to the extent that the person that gave the bank instructions has a claim to those funds if the bank does not make the future payment.]

(hh) A secured creditor has “control” with respect to a right to payment of funds credited to a bank account:

- (i) Automatically upon the creation of a security right if the depositary bank is the secured creditor;

(ii) If the depositary bank has concluded a control agreement with the grantor and the secured creditor, according to which the depositary bank has agreed to follow instructions from the secured creditor with respect to the right to payment of funds credited to the bank account without further consent of the grantor; or

(iii) If the secured creditor is the account holder;

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that: (a) there is no obligation on a depositary bank to enter into a control agreement; (b) that a secured creditor's rights will be subject to the rights and obligations of the depositary bank under law and practice governing bank accounts; and (c) a control agreement requires the consent of the grantor (as well as of the depositary bank) and the grantor retains the right to deal with the funds in the bank account until the secured creditor instructs the depositary bank otherwise (although in some control agreements the funds would be blocked from the time of the conclusion of the control agreement). The commentary will also explain that subparagraph (c) covers situations where: (a) an existing account is transferred to the secured creditor; (b) the secured creditor agrees with the grantor that funds should be deposited to an account to be opened later; and (c) the secured creditor is the only account holder (i.e. not merely a joint account holder).]

(ii) "Intellectual property right" includes patents, trademarks, service marks, trade secrets, copyright and related rights and designs. It also includes rights under licences of such rights;

(jj) "Proceeds" means whatever is received in respect of encumbered assets. For example, proceeds include what is received as a result of sale or other disposition, collection, lease or licence of an encumbered asset, proceeds of proceeds, civil and natural fruits, dividends, distributions, insurance proceeds and claims arising from defects, damage or loss;

(kk) "Priority" means the right of a person to derive the economic benefit of its security right in an encumbered asset in preference to a competing claimant;

(ll) "Competing claimant" means:

(i) Another secured creditor with a security right in the same encumbered asset (whether as an original encumbered asset or proceeds);

(ii) In the context of the non-unitary system for acquisition security rights, the seller, financial lessor or purchase-money lender of the same encumbered asset that has retained title to it;

(iii) Another creditor of the grantor asserting a right in the same encumbered asset (e.g. by operation of law, attachment or seizure or similar process);

(iv) The insolvency representative in the insolvency of the grantor;² or

(v) Any buyer or other transferee (including a lessee or licensee) of the encumbered asset;

² In the chapter on insolvency, reference is made to "the insolvency of the debtor" for reasons of consistency with the terminology used in the *UNCITRAL Legislative Guide on Insolvency Law* (see footnote 55).

(mm) “Possessory security right” means a security right in tangibles that are in the actual possession of the secured creditor or of another person (other than the debtor or other grantor) holding the asset for the secured creditor;

(nn) “Non-possessory security right” means a security right in: (i) tangibles that are not in the actual possession of the secured creditor or another person holding the tangibles for the benefit of the secured creditor, or (ii) intangibles;

[Note to the Working Group: The Working Group may wish to consider whether subparagraphs (mm) and (nn) are necessary after the decision not to make such a distinction between possessory and non-possessory security rights. The terms are used only in recommendations 1, subparagraph (e) (key objectives), and 2, subparagraph (d) (assets, parties, secured obligations and security rights).]

(oo) “Possession”, except as the term is used in recommendations 27 and 48-50 with respect to the issuer of a negotiable document, means the actual possession of tangibles by a person or an agent or employee of that person, or by another person holding on behalf of that person, or an independent person that acknowledges that it holds for that person. It does not include constructive, fictive or symbolic possession;

(pp) “Issuer” of a negotiable document means the person that is obligated to deliver the tangibles covered by the document under the law governing negotiable documents;

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that, in the case of a so-called multimodal bill of lading (if it qualifies as a negotiable document under the applicable law), the “issuer” may be a person that subcontracts various portions of the transport of the goods to other persons but still takes responsibility for their transport and for any damage that might occur during carriage.]

(qq) “Insolvency court” means a judicial or other authority competent to control or supervise an insolvency proceeding;

(rr) “Insolvency estate” means assets and rights of the debtor that are controlled or supervised by the insolvency representative and subject to the insolvency proceedings;

(ss) “Insolvency proceedings” means collective judicial or administrative proceedings for the purposes of either reorganization or liquidation of the debtor’s business conducted according to the insolvency law;

(tt) “Insolvency representative” means a person or body responsible for administering the insolvency estate;

(uu) “Buyer in the ordinary course of business” means a person that buys inventory in the ordinary course from a person in the business of selling tangibles of that kind and without knowledge that the sale violates the rights of the secured creditor under the security agreement [or other rights of another person in the tangibles];

(vv) “Lessee in the ordinary course of business” means a person that leases inventory in the ordinary course from a person in the business of leasing tangibles of that kind and without knowledge that the lease violates the rights of the secured creditor under the security agreement [or other rights of another person in the tangibles];

(ww) “Licensee in the ordinary course of business” means a person that licenses intangible property in the ordinary course from a person in the business of licensing property of that kind and without knowledge that the license violates the rights of the secured creditor under the security agreement [or other rights of another person in the property];

[Note to the Working Group: The Working Group may wish to note that the terms “buyer in the ordinary course of business”, “lessee in the ordinary course of business” and “licensee in the ordinary course of business” are referred to in recommendation 83 (rights of buyers, lessees and licensees of encumbered assets). The commentary will clarify that it is possible for a buyer, lessee or licensee to know of the existence of a security right but not know whether the transfer violates the terms of the security agreement. The commentary will also explain that, in the rare cases in which the buyer of inventory has knowledge not only of the security right but also that the sale violates the terms of the security agreement, the buyer will not qualify as a buyer in the ordinary course of business and, therefore, not take free under recommendation 83, subparagraph (a). The commentary will also clarify that the test in recommendations 83 is the same as in recommendations 94 priority of a security right in a right to payment of funds credited to a bank account) and 95 (priority of a security right in money).]

(xx) “Consumer goods” means goods intended to be used for personal, family or household purposes.

Recommendations³

I. Key objectives of an effective and efficient secured transactions law⁴

Purpose

The purpose of the recommendation on key objectives is to provide a broad policy framework for the establishment and development of an effective and efficient secured transactions law. This recommendation could be included in a preamble to the secured transactions law as a guide to the underlying legislative policies to be taken into account in the interpretation and the application of the secured transactions law (hereinafter referred to as “the law”).

Key objectives

1. The law should be designed:
 - (a) To promote secured credit;
 - (b) To allow utilization of the full value inherent in a broad range of assets to support credit in the widest possible array of credit transactions;
 - (c) To enable parties to obtain security rights in a simple and efficient manner;

³ The recommendations in the present document are based on recommendations contained in the document indicated in a footnote next to the title of each chapter, unless otherwise indicated in a footnote next to the title of a particular recommendation or note.

⁴ See A/CN.9/WG.VI/WP.26/Add.7.

- (d) To provide for equal treatment of diverse sources of credit and of diverse forms of secured transactions;
- (e) To validate non-possessory security rights;
- (f) To encourage responsible behaviour on the part of all parties by enhancing predictability and transparency;
- (g) To establish clear and predictable priority rules;
- (h) To facilitate enforcement of creditor's rights in a predictable and efficient manner;
- (i) To balance the interests of affected persons;
- (j) To recognize party autonomy; and
- (k) To harmonize secured transactions laws, including conflict-of-laws rules.

II. Scope of application⁵

Purpose

The purpose of the scope provisions of the law is to establish a single comprehensive regime for secured transactions. It should specify the assets, the parties, the secured obligations and the security rights to which the law applies.

Assets, parties, secured obligations and security rights

2. The law should apply:

(a) To all types of movable property and attachment, tangible or intangible, present or future, including inventory, equipment and other goods, contractual and non-contractual receivables, contractual non-monetary obligations, negotiable instruments, negotiable documents, rights to payment of funds credited to a bank account, proceeds under an independent undertaking and intellectual property rights;

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that the general recommendations, as supplemented by the recommendations on receivables apply to: (a) contractual and non-contractual receivables (however, recommendations 22 and 109 do not apply to non-contractual receivables); and (b) contractual non-monetary obligations. The commentary will also explain that law other than the law recommended in the Guide applies to the rights of obligors of contractual non-monetary obligations (see also notes to definition (p), "receivable" and recommendations 22 and 109).]

(b) To all legal and natural persons, including consumers, without, however, affecting their rights under consumer-protection legislation;

(c) To all types of obligation, present or future, determined or determinable, including fluctuating obligations and obligations described in a generic way;

(d) To all types of possessory and non-possessory security right in movable property;

⁵ See A/CN.9/WG.VI/WP.26/Add.7.

(e) To all types of property right created contractually to secure the payment or other performance of an obligation, irrespective of the form of the relevant transaction, including the various forms of retention of title, financial leases and hire-purchase agreements, as well as transfers of title by way of security.

[Note to the Working Group: The Working Group may wish to note that the commentary will clarify that, while the Guide applies to security rights (defined as consensual security rights), the chapter on priority applies to priority contests between consensual and non-consensual security rights.]

Outright transfers of receivables⁶

3. The law should apply to outright transfers of receivables, subject to recommendation 160 (application of the chapter on enforcement to outright transfers of receivables).

[Note to the Working Group: The Working Group may wish to note that, as definition (p), “receivable”, excludes rights to payment under a negotiable instrument, the obligation to pay under an independent undertaking and the obligation of a bank to pay funds credited to a bank account, recommendation 3 does not apply to an outright transfer of a negotiable instrument, proceeds under an independent undertaking or a right to payment of funds credited to a bank account. However, the recommendations of the Guide apply to transfers of such assets for security purposes, as they are treated as secured transactions.]

The commentary will explain that outright transfers of negotiable instruments, proceeds under an independent undertaking and funds credited to a bank account have been excluded as: (a) they raise different issues and would require special rules; and (b) unlike receivables in which a security transfer and an outright transfer would compete for priority based on the order of registration, with respect to negotiable instruments a secured creditor could always obtain a superior right by taking possession of the instrument. Similarly, with respect to proceeds under an independent undertaking and rights to payment of funds credited to a bank account, a secured creditor could always obtain a superior right by control. The commentary will also discuss issues arising in outright transfers of negotiable instruments other than cheques for the benefit of States that may wish to address them in the law (for this note, see A/CN.9/611, note to recommendation 3, subparagraph (f)).

In that connection, the Working Group may wish to note that the commentary will explain that, while principles of secured transactions law can easily be made to apply to the outright transfer of promissory notes and, perhaps, bills of exchange other than cheques, in a manner similar to the Guide’s coverage of the outright transfer of receivables, those principles do not apply well to the outright transfer of cheques. The latter topic is sufficiently covered by the law of negotiable instruments and the law of bank collections.

The commentary will also explain that an enacting State that wishes to expand the scope of its secured transactions law to apply to outright transfers of negotiable instruments that are either promissory notes or bills of exchange (and to expand its definition of “security right” to cover the right of the transferee in such a transaction) might wish to consider providing that a security right that is an outright transfer of such a negotiable instrument is automatically effective against

⁶ See A/CN.9/611, recommendation 3, subparagraph (f).

third parties upon the transfer. Such a rule would avoid disrupting existing financial practices.

In addition, the commentary will explain that, with respect to the priority of such a security right, the general principles of priority would apply. Most particularly, the general principle in recommendation 76, as qualified by recommendations 89 and 90, would govern. As in the case of an outright transfer of a receivable, the outright transferee of such a negotiable instrument should be able to enforce the instrument without further consent of the assignor subject to the rights of the obligors on the negotiable instrument as described in the chapter on enforcement (for the preceding 3 paragraphs, see A/CN.9/611/Add.1, note to recommendation 3, subparagraph (f)).]

Aircraft, railway rolling stock, space objects, ships and intellectual property

4. Notwithstanding recommendation 2, subparagraph (a), the law should not apply:

(a) To aircraft, railway rolling stock, space objects, ships and attachments thereto to the extent that the recommendations of this law are inconsistent with existing special laws or international obligations of the State relating to these types of asset. Where a direct inconsistency exists, the law should expressly confirm that the special laws and international obligations govern those assets to the extent of that inconsistency;

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that the reference to “aircraft, railway rolling stock, space objects and ships” should be understood pursuant to the meaning of those terms in national law or international conventions dealing with them.]

(b) To intellectual property rights to the extent that the recommendations of this law are inconsistent with existing laws or international obligations of the State relating to these assets.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that a State enacting secured transactions legislation in accordance with the Guide should consider whether it might be appropriate to adjust certain of the recommendations as they apply to security rights in intellectual property. In this regard, a State should examine its existing intellectual property laws and the State’s obligations under intellectual property treaties, conventions and other international agreements and, in the event that the recommendations of the Guide are directly inconsistent with any such existing laws or obligations, the State’s secured transactions law should expressly confirm that those existing intellectual property laws and obligations govern such issues to the extent of the inconsistency.]

In considering whether any adjustments of the recommendations as they apply to security rights in intellectual property are appropriate, a State should analyse each circumstance on an issue-by-issue basis and should have proper regard both to establishing an efficient secured transactions regime and to ensuring the protection and exercise of intellectual property rights in accordance with international conventions and national laws.

The Working Group may wish to note that, at its thirty-ninth session, the Commission requested the Secretariat to prepare a paper on intellectual property

financing for consideration at its fortieth session with a view to providing further guidance to States with respect to intellectual property financing.]

Securities and immovable property

5. The law should provide that it does not apply to [indirectly held] securities and immovable property, although it may affect such assets, as provided in recommendations 24 and 45.

[Note to the Working Group: The Working Group may wish to note that securities and immovable property are excluded from the scope of the Guide as original encumbered assets. However, they may be affected by the recommendations of the Guide.]

If a security right in securities or a mortgage secures a receivable, negotiable instrument or other obligation and the receivable, negotiable instrument or other obligation is assigned, the security right in the securities or the mortgage follows. This rule does not affect any third-party rights, priority and enforcement requirements existing under securities or immovable property law. For example, a security right in intermediated securities that was made effective against third parties by a book entry or control under securities law will have priority.

The Working Group may wish to consider whether, if securities or immovable property are proceeds of an asset covered in the Guide, the security right extends to such proceeds. If so, language may need to be added to ensure that third-party rights, priority and enforcement of the security right in securities or immovable property as proceeds are subject to securities or immovable property law as applicable.

In addition, the Working Group may wish to note that the bracketed text in recommendation 5 is intended to avoid excluding from the scope of the Guide directly held securities to the extent they are not subject to any special legislation (even the UNIDROIT draft Convention on Substantive Rules Regarding Intermediated Securities does not apply to directly held securities). Thus, no gap would be left with respect to, for example, security rights in shares of a subsidiary all held by the parent company, since such security rights are involved in significant commercial loan transactions.]

Employment payments

6. The law should provide that it does not apply to receivables in the form of remunerations, retirement payments, employment benefits and other payments accruing from employment contracts or relations, as well as other similar payments (e.g. family support payments) to the extent that law other than this law restricts the grant of security rights in or the transfer of such receivables.

Other exceptions

7. The law should limit any other exceptions to its scope of application and, to the extent any other exceptions are made, they should be set forth in the law in a clear and specific way.

III. Basic approaches to security and other general rules⁷

Purpose

The purpose of the recommendations on basic approaches to security is to ensure that the law covers in an integrated and consistent manner all forms of rights in movable property that serve security purposes.

Integrated and functional approach

8. The law should establish an integrated and consistent set of provisions on security rights in tangibles and intangibles. Its rules should apply to all contractually created rights (regardless of form) in movable property that secure an obligation, including rights under a transfer of title to tangibles or an assignment of receivables for security purposes, a retention of title sale, a financial lease or a hire-purchase agreement [, except to the extent otherwise provided in recommendations 171 (non-unitary approach to acquisition financing devices, alternative B) and 193 (enforcement of ownership rights under retention-of-title devices, non-unitary approach, alternative B)].

Party autonomy

9. The law should provide that, except as otherwise provided in [specify the provisions that may not be derogated from or varied by agreement, e.g. standard of conduct in the context of enforcement], the secured creditor and the grantor or the debtor may derogate from or vary by agreement its provisions relating to their respective rights and obligations. Such an agreement does not affect the rights of any person that is not a party to the agreement.

Electronic communications

10. The law should provide that, where it requires that a communication or a contract should be in writing, or provides consequences for the absence of a writing, that requirement is met by an electronic communication if the information contained therein is accessible so as to be usable for subsequent reference.

[Note to the Working Group: The Working Group may wish to note that this recommendation tracks the language of article 9 (2) of the United Nations Electronic Contracting Convention, which is consistent with article 6 of the UNCITRAL Model Law on Electronic Commerce.]

11. [The law should provide that, where the law requires that a communication or a contract should be signed by a person, or provides consequences for the absence of a signature, that requirement is met in relation to an electronic communication if:

(a) A method is used to identify the party and to indicate that person's intention in respect of the information contained in the electronic communication; and

(b) The method used is either:

(i) As reliable as appropriate for the purpose for which the electronic communication was generated or communicated, in the light of all the circumstances, including any relevant agreement; or

⁷ See A/CN.9/WG.VI/WP.26/Add.7.

- (ii) Proven in fact to have fulfilled the functions described in subparagraph (a) above, by itself or together with further evidence].

[Note to the Working Group: The Working Group may wish to note that this recommendation tracks the language of article 9 (3) of the United Nations Electronic Contracting Convention, which is consistent with article 7 of the UNCITRAL Model Law on Electronic Commerce. The Working Group may also wish to note that according to recommendation 116, subparagraph (c) (agreement not to raise defences or rights of set-off), a signed writing is required for a waiver of the defences of the debtor of a receivable.]

IV. Creation of a security right (effectiveness as between the parties)⁸

Purpose

The purpose of the provisions of the law dealing with creation is to specify the way in which a security right in movable property is created (i.e. becomes effective as between the parties).

A. General recommendations

Creation of a security right

12. The law should provide that a security right is created by agreement between the grantor and the secured creditor that identifies the secured creditor and the grantor and reasonably describes the secured obligation and the assets to be encumbered. A generic description of the encumbered assets is sufficient (e.g. “all assets” or “all inventory”).

13. The law should provide that the agreement may be oral if accompanied by transfer of possession of the encumbered asset. Otherwise, the agreement must be in a writing [signed by the grantor in accordance with recommendation 11] [that evidences the intent of the grantor to grant a security right].

Time of creation

14. The law should provide that a security right is created when the requirements for the security agreement under recommendations 12 and 13 (creation of a security right) are fulfilled and the grantor has rights in the assets or the right to encumber the assets, unless the parties agree to a later date.

Obligations subject to a security agreement⁹

15. The law should provide that a security right may secure any type of obligation, present or future, determined or determinable, as well as conditional and fluctuating obligations.

⁸ See A/CN.9/WG.VI/WP.26/Add.7.

⁹ See A/CN.9/611.

Assets subject to a security agreement

16. The law should provide that a security right may be given in any type of asset, including parts of assets and undivided interests in assets. A security agreement may cover assets that, at the time the security agreement is concluded, may not yet exist or that the grantor may not yet own or have the power to encumber. Any exceptions to these rules should be limited and described in the law in a clear and specific way.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that a security right in future assets or assets belonging to third parties is not created until the grantor acquires a right in those assets. Other law (e.g. sales or property law) may permit a person to grant a security right or otherwise dispose of assets that it does not own (e.g. a rule that protects a good faith transferee that acquires a right from a grantor in possession of assets it does not own).]

17. The law should provide that a security right may be granted in all assets of a grantor.

[Note to the Working Group: The Working Group may wish to note that the commentary discusses an approach taken in some legal systems of preserving in the case of insolvency of a person that has granted a security right in all its assets (for a discussion of all-asset security, see A/CN.9/WG.VI/WP.11/Add.2, paras. 20-25) a certain percentage of the value of the encumbered assets for unsecured creditors (see A/CN.9/WG.VI/WP.9/Add.6, paras. 33-35). However, for the reasons set forth in the commentary, the Guide does not recommend this approach (see recommendation 85 (priority of preferential claims)).]

Creation of a security right in proceeds¹⁰

18. The law should provide that, unless otherwise agreed by the parties to the security agreement, the security right in the encumbered asset extends to its identifiable proceeds.

19. [The law should provide that, notwithstanding recommendation 18, the security right extends to proceeds in the form of civil and natural fruits of encumbered assets, only if the parties so provide in the security agreement.]

[Note to the Working Group: The Working Group may wish to note that recommendation 19 introduces a different approach to civil and natural fruits of encumbered assets from the approach taken in recommendation 18 with respect to other types of proceeds. However, the notion of “proceeds”, as defined in the terminology section, includes civil and natural fruits, and the natural expectation may be that the security right will extend automatically to civil and natural fruits. Thus, the Working Group may wish to consider deleting recommendation 19.]

In addition, the Working Group may wish to consider all the definitions and recommendations on security rights in proceeds together (i.e. definition (jj) and recommendations 18-21, 43-44, 80, 173-174, 191-192 and 198). The Working Group may also wish to note that the commentary will make clear that these recommendations have to be read together.]

¹⁰ See A/CN.9/WG.VI/WP.26/Add.4, recommendations 29, 29 bis and 30.

Commingled proceeds

20. The law should provide that, where proceeds in the form of money have been commingled with other property so that the proceeds are not identifiable, the amount of the proceeds immediately before they were commingled with other property is to be treated as identifiable proceeds, provided that, at any time after commingling, the total amount of the property was more than the amount of the proceeds. If, at any time after commingling, the total amount of the property was less than the amount of the proceeds, the total amount of the property at the time that its amount was lowest plus the amount of any proceeds later commingled with the property is to be treated as identifiable proceeds.

21. The law should provide that, where proceeds other than money have been commingled with other property of the same type so that the proceeds are not identifiable, the share of the total property which the value of the proceeds bears to the total value of the property is to be treated as identifiable proceeds.

[Note to the Working Group: The Working Group may wish to note that recommendation 20 focuses on money as: (a) commingled proceeds other than money, is a fairly rare phenomenon; and (b) tracing rules for those situations are also rare. However, recommendation 21 might be applied in cases in which proceeds are fungible items that are commingled with other items of the same type (e.g. when the proceeds of a barter transaction consist of grain stored in a common grain elevator).]

B. Asset-specific recommendations

Effectiveness of a bulk assignment and an assignment of future, parts of and undivided interests in receivables¹¹

22. The law should provide that:

(a) An assignment of [contractual] receivables that are not specifically identified, future receivables and parts of or undivided interests in receivables is effective as between the assignor and the assignee and as against the debtor of the receivable, as long as, at the time of the assignment or, in the case of future receivables, at the time they arise, they can be identified to the assignment to which they relate; and

(b) Unless otherwise agreed, an assignment of one or more future receivables is effective without a new act of transfer being required to assign each receivable.

[Note to the Working Group: The Working Group may wish to note that the bracketed text in subparagraph (a) of this recommendation is intended to ensure that statutory limitations to the assignability of non-contractual receivables are not interfered with (see A/CN.9/603, para. 36 and notes to definition (p), "receivable", and recommendations 2, subparagraph (a), and 109). The Working Group may wish to consider all the definitions and recommendations on security rights in receivables together (i.e. definitions (a), (p)-(w) and recommendations 18-20, 22-24, 45, 108-118, 160-162, 172, 192, 197, 207 and 213). The Working Group may wish to

¹¹ For recommendations 22-24, see A/CN.9/611, recommendations 14-16.

note that the commentary will make clear that these recommendations, as well as all the other-specific recommendations, have to be read together.]

Effectiveness of an assignment made despite an anti-assignment clause

23. The law should provide that:

(a) An assignment is effective as between the assignor and the assignee and as against the debtor of the receivable notwithstanding an agreement between the initial or any subsequent assignor and the debtor of the receivable or any subsequent assignee limiting in any way the assignor's right to assign its receivables;

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that subparagraph (a) of this recommendation makes ineffective only an agreement between an obligor and an obligee that limits the obligee's right to assign a receivable owed by the obligor to the obligee. If such a receivable is assigned, the obligor is the "debtor of the receivable" and the obligee is the "assignor".

For example, if an agreement for the lease of goods limits the lessor's right to assign the rents due to it under the lease, subparagraph (a) makes the limitation on assignment ineffective, because the agreement is between the obligor (the lessee) and the obligee (the lessor) of the receivable (the rent arising from the lease agreement). By way of contrast, if the lease agreement between the lessor and the lessee limits the lessee's right to assign a receivable consisting of the lessee's claim to rents due to the lessee from the sublessee under a sublease, subparagraph (a) has no application and nothing in the Guide makes the limitation ineffective. That is because the agreement limiting the right of the lessee to assign its claim for rents due to it from the sublessee under the sublease is not an agreement between the lessee (sublessor and obligee in a sublease) and the sublessee (obligor in the sublease). Whether the limitation in the lease is enforceable against the lessee would be determined by the law other than the law recommended in the Guide.

The same analysis would apply if the restriction on transfer was contained in a licence of intellectual property. Subparagraph (a), would render ineffective a term in the licence agreement that restricted the licensor from assigning fees due from the licensee. However, it would not render ineffective a term in the licence agreement restricting the licensee from assigning sublicense fees. Whether the latter term would be effective would be determined by law other than that recommended in the Guide.

The commentary will also explain that States that cannot protect themselves through statutory limitations on assignment may wish to consider an exception to this recommendation along the lines of article 40 of the United Nations Assignment Convention.]

(b) Nothing in this recommendation affects any obligation or liability of the assignor for breach of such an agreement, but the other party to such an agreement may not avoid the original contract or the assignment contract on the sole ground of that breach. A person that is not a party to such an agreement is not liable on the sole ground that it had knowledge of the agreement;

- (c) This recommendation applies only to assignments of receivables:
 - (i) Arising from an original contract that is a contract for the supply or lease of goods or services other than financial services, a construction contract or a contract for the sale or lease of immovable property;
 - (ii) Arising from an original contract for the sale, lease or licence of industrial or other intellectual property or of proprietary information;
 - (iii) Representing the payment obligation for a credit card transaction;
 - (iv) Owed to the assignor upon net settlement of payments due pursuant to a netting agreement involving more than two parties.

[Note to the Working Group: The Working Group may wish to note that the commentary will clarify that the contract avoidance referred to in subparagraph (b) means contract termination in general.]

Creation of a security right in a right that secures a receivable, a negotiable instrument or any other obligation

24. The law should provide that:

(a) A secured creditor with a security right in a receivable, negotiable instrument or any other obligation covered as an encumbered asset by this law automatically has the benefit, without further action by either the grantor or the secured creditor, of any personal or property right that secures payment or other performance of the receivable, negotiable instrument or other obligation;

(b) If the personal or property right is an independent undertaking, the security right automatically extends to the proceeds under the independent undertaking but does not extend to the right to draw under the independent undertaking;

(c) This recommendation does not apply to a right in immovable property that under law other than this law is transferable separately from a receivable, negotiable instrument or other obligation that it may secure;

(d) A secured creditor with a security right in a receivable, negotiable instrument or any other obligation has the benefit of any personal or property right securing payment or other performance of the receivable, negotiable instrument or other obligation notwithstanding any agreement between the grantor and the debtor of the receivable or the obligor of the negotiable instrument or other obligation limiting in any way the grantor's right to create a security right in the receivable, negotiable instrument or other obligation, or in any personal or property right securing payment or other performance of the receivable, negotiable instrument or other obligation;

(e) Nothing in this recommendation affects any obligation or liability of the grantor for breach of the agreement mentioned in subparagraph (d) of this recommendation, but the other party to such an agreement may not avoid the contract from which the receivable, negotiable instrument or other obligation arises, or the security agreement creating the personal or property security right on the sole ground of that breach. A person that is not a party to such an agreement is not liable on the sole ground that it had knowledge of the agreement;

(f) Subparagraphs (d) and (e) of this recommendation apply only to security rights in receivables, negotiable instruments or other obligations:

(i) Arising from an original contract that is a contract for the supply or lease of goods or services other than financial services, a construction contract or a contract for the sale or lease of immovable property;

(ii) Arising from an original contract for the sale, lease or licence of industrial or other intellectual property or of proprietary information;

(iii) Representing the payment obligation for a credit card transaction;

(iv) Owed to the assignor upon net settlement of payments due pursuant to a netting agreement involving more than two parties.

(g) The rule in subparagraph (a) of this recommendation does not affect any duties of the grantor to the debtor of the receivable or to the obligor of the negotiable instrument or other obligation;

(h) To the extent that the automatic effects under subparagraph (a) of this recommendation and the automatic third-party effectiveness under recommendation 45 of a security right in any personal or property security right securing payment or other performance of a receivable, negotiable instrument or other obligation is not impaired, this recommendation does not affect any requirement under law other than this law relating to the form or registration of the creation of security rights in any assets, securing payment or other performance of a receivable, negotiable instrument or other obligation, that are outside the scope of this law.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that the purpose of this recommendation is to facilitate financing transactions, such as securitizations of pools of loans secured by security rights in movable and immovable property. In these cases the buyer of the loans will want to be able to look to the security rights securing the loans but would not want to incur, at the outset of the purchase, the additional expense of a separate act of transfer (if required under law other than the law recommended in the Guide) for each loan in the pool of loans, which could number in the hundreds or thousands. Separate acts of transfer, if any, would be necessary (if required under other law) to enforce only those loans which are later in default, typically a small proportion of the loans in the pool actually purchased. The buyer could decide whether to accept the expense of separate acts of transfer at the time of enforcement, whether voluntarily from the seller or with the assistance of a court. In deciding whether to purchase the loans and at what price, however, the buyer would take into account the expense of separate acts of transfer only for the small portion of the loans expected to be in default, not for the entire pool of loans. As a result of the expense savings, the seller should be able to obtain a higher purchase price, thereby making more funds available to the seller.]

The commentary will also make it clear that this recommendation applies to outright transfers of receivables (but not of negotiable instruments or other obligations), as the Guide generally applies only to outright transfers of receivables.

The commentary will also clarify that subparagraphs (a) to (c) track the language of article 10, paragraph (1), of the United Nations Assignment Convention with appropriate adjustments necessary in view of the nature of the law in the Guide

as domestic law, while subparagraphs (e) and (f) track the language of recommendation 23, subparagraphs (b) and (c), as well as article 10, paragraphs (3) and (4), of the United Nations Assignment Convention.

In addition, the commentary will clarify that subparagraph (g) tracks the language of article 10, paragraph (5), of the United Nations Assignment Convention, according to which, if the security right involves the delivery of possession of an asset and such delivery causes damage to the debtor of the receivable or the obligor of the negotiable instrument or other obligation, any liability that may exist under law applicable outside the law recommended in the Guide is not affected. Such liability may arise, for example, in the case of a delivery of possession of an item of valuable tangible property if the secured creditor or transferee damages or loses the property.

Furthermore, the commentary will clarify that subparagraph (h), which tracks the language of article 10, paragraph (6), of the United Nations Assignment Convention, makes it clear that the form of transfer of a security right in an asset outside the scope of this law (e.g. an immovable) is left to law other than this law, at least to the extent that the automatic creation and third-party effectiveness of a security right is not impaired. Accordingly, a notarized document and registration may be necessary for the transferee of a mortgage to obtain various rights under immovable property law, such as the right to enforce the mortgage. The commentary will further explain that the form of transfer of a security right in an asset within the scope of this law will be subject to this law.]

Creation of a security right in a negotiable instrument¹²

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that, pursuant to recommendations 12 and 13, a security right in a negotiable instrument may be created by a written and possibly signed agreement between the grantor and the secured creditor or by an oral agreement and transfer of possession of the negotiable instrument. The commentary will also explain that creation of a security right pursuant to these recommendations will not affect rights obtained by endorsement of the negotiable instrument under the law governing negotiable instruments.]

In addition, the Working Group may wish to consider all the definitions and recommendations on security rights in negotiable instruments together (i.e. definition (x), and recommendations 45, 89-90, 119, 163-164, 195, 209 and 213). The Working Group may also wish to note that the commentary will make clear that these recommendations have to be read together.]

Creation of a security right in a right to payment of funds credited to a bank account¹³

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that, pursuant to recommendations 12 and 13, a security right in a right to payment of funds credited to a bank account may be created by agreement between the grantor and the secured creditor. The commentary will also explain that the purpose of recommendation 25 is to validate as between the grantor

¹² See A/CN.9/611/Add.1.

¹³ See A/CN.9/611/Add.1, recommendation 26.

and the secured creditor (but not as against the depositary bank) a security right created in a right to payment of funds credited to a bank account despite an anti-assignment agreement between the depositary bank and the grantor (holder of the account).]

25. The law should provide that a security right in a right to payment of funds credited to a bank account is effective notwithstanding an agreement between the grantor and the depositary bank limiting in any way the grantor's right to create a security right in its right to payment of funds credited to the bank account. However, the depositary bank has no duty to recognize the secured creditor and no obligation is otherwise imposed on the depositary bank with respect to the security right without the depositary bank's consent.

[Note to the Working Group: The Working Group may wish to note that the commentary to recommendation 2, subparagraph (b), will clarify that enacting States may wish to take into account any impact that the recommendations in the Guide might have on consumer-protection law.]

In addition, the Working Group may wish to consider all the definitions and recommendations on rights to payment of funds credited to a bank account together (i.e. definitions (gg) and (hh), as well as recommendations 25, 46, 92-94, 120-121, 165-167, 208-209 and 213). The Working Group may also wish to note that the commentary will make clear that these recommendations have to be read together.]

Creation of a security right in proceeds under an independent undertaking¹⁴

26. The law should provide that a beneficiary may grant a security right in proceeds under an independent undertaking, even if the right to draw under the independent undertaking is itself not transferable under law and practice governing independent undertakings. The grant of a security right in proceeds under an independent undertaking is not a transfer of the right to draw under an independent undertaking. [Whether the right to draw under an independent undertaking may be transferred is a matter governed by the law and practice governing independent undertakings.]

[Note to the Working Group: The Working Group may wish to note that the commentary will make clear that the second part of the first sentence clarifies the important point that transferability of an independent undertaking itself (i.e. the right to draw) is irrelevant to the right to create a security right in the proceeds under the independent undertaking. The commentary will also explain that the second sentence distinguishes a right to request payment under an independent undertaking from a right to receive the proceeds under an independent undertaking.]

The Working Group may wish to consider whether the bracketed third sentence should be part of the recommendation or the commentary as it states what other law provides and not what this law should provide. In addition, the Working Group may wish to consider all the definitions and recommendations on security rights in proceeds under an independent undertaking together (i.e. definitions (z) and (aa)-(ff), and recommendations 26, 47, 96, 122-124, 168 and 210-212). The Working Group may also wish to note that the commentary will make clear that these recommendations have to be read together.]

¹⁴ See A/CN.9/611/Add.1, recommendation 25.

Creation of a security right in a negotiable document¹⁵

27. The law should provide that the creation of a security right in a negotiable document also creates a security right in the goods represented by the document, provided that the issuer is in possession of the goods, directly or indirectly, at the time the security right in the document is created.

[Note to the Working Group: The Working Group may wish to note that the commentary will clarify that a security right in goods covered by a negotiable document may be created pursuant to recommendations 12 and 13 (by a written and possibly signed agreement between the grantor and the secured creditor or even by an oral agreement and transfer of possession of the document) directly in the goods or pursuant to recommendation 27 through the creation of a security right in the negotiable document covering the goods. In addition, the commentary will clarify that recommendation 27 is intended to obviate that, in situations where a security right exists in a negotiable document, a separate security right needs to be created in the goods covered by the document. Moreover, the commentary will explain that neither recommendations 12 and 13 nor recommendation 27 nor any other recommendation affects rights in negotiable documents acquired under the law governing negotiable documents.]

For the benefit of enacting States that may wish to consider addressing multi-modal transport documents, the commentary will also explain that, as the definition of a negotiable document in the Guide is left to the law governing negotiable documents, the negotiability of multi-modal transport documents is also left to that law. The Working Group may wish to consider all the definitions and recommendations on security rights in negotiable documents together (i.e. definitions (y), (oo) and (pp), and recommendations 27, 48-50, 97-98, 169, 125, 195 and 213). The Working Group may also wish to note that the commentary will make clear that these recommendations have to be read together.]

Creation of a security right in attachments¹⁶

28. The law should provide that a security right may be created in tangibles that are attachments at the time of creation of the security right or continue in tangibles that become attachments subsequently. Security rights in attachments to immovable property may be created under this law or law on immovable property.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that, if the security right in attachments to immovable property is created under the law of immovable property, the security right may at the same time be effective against third parties. The commentary will also explain that, if such a security right is created under the secured transactions law, rights of persons that have rights under immovable property law may not be affected. For example, a security right created under secured transactions law may be enforced only if there are no competing rights created under immovable property law or has no priority over competing rights acquired under immovable property law (see recommendation 99).]

In addition, the Working Group may wish to consider all the definitions and recommendations on security rights in attachments together (i.e. definitions (l) and

¹⁵ See A/CN.9/611/Add.1, recommendation 28.

¹⁶ See A/CN.9/WG.VI/WP.26/Add.4, recommendation 31.

(m), as well as recommendations 28, 51-53, 99-102, 170, 189, 195 and 200-201). The Working Group may also wish to note that the commentary will make clear that these recommendations have to be read together.]

Creation of a security right in a mass or product¹⁷

29. The law should provide that a security right may not be created in tangibles that are commingled in a mass or product. However, a security right created in tangibles before they were commingled in a mass or product continues in the mass or product. The security right is limited to the value of the tangibles immediately before they became part of the mass or product.

[Note to the Working Group: The Working Group may wish to note that the commentary will clarify that a security right may not be created in tangibles that are commingled in a mass or product as, at the time of creation of the security right, they do not exist as separate tangibles (see definition (n), “mass or product”). The commentary will also explain that a security right in the goods before they became commingled in a mass or product continues in the mass or product according to the formula contained in the third sentence of this recommendation. Under this formula, if the value of flour is 5 and the value of sugar is 5, while the value of the cake produced is 20 and there are two secured creditors, each secured creditor will get 5, while the remaining value of 10 will be preserved for the grantor and its unsecured creditors. If the value of the cake is lower than the value of the ingredients, the secured creditors will share the loss proportionately (e.g. if the value of the cake is 8, each secured creditor will get 4). This means that: (a) the secured creditor cannot get more than owed; and (b) if the value of the mass or product is less, the secured creditor will suffer a proportionate diminution (this is a priority issue).]

In addition, the Working Group may wish to consider all the definitions and recommendations on security rights in masses or products together (i.e. definition (n) and recommendations 29, 54, 103-105 and 195). The Working Group may also wish to note that the commentary will make clear that these recommendations have to be read together.]

V. Effectiveness of a security right against third parties¹⁸

Purpose

The purpose of the requirements of the law for the effectiveness of a security right against third parties is to create a foundation for the predictable, fair and efficient ordering of priorities by:

(a) Requiring registration as a precondition for the effectiveness of a security right against third parties, except where exceptions and alternatives to registration are appropriate in light of countervailing commercial policy considerations; and

(b) Establishing a legal framework to create and support a simple, cost-efficient and effective public registry system for the registration of notices with respect to security rights.

¹⁷ See A/CN.9/WG.VI/WP.26/Add.4, recommendation 32.

¹⁸ See A/CN.9/WG.VI/WP.26/Add.5.

A. General recommendations

Meaning of third-party effectiveness

30. The law should provide that a security right is effective against third parties only if it is created in accordance with this law and one of the methods referred to in recommendation 33, 35 or 36 has been followed.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that recommendation 30 is intended to clarify the meaning of third-party effectiveness because of its importance for both the third-party effectiveness and the priority chapter and the fact that third-party effectiveness separate from effectiveness as between the parties is a new notion to many legal systems. Recommendation 30 is supplemented by recommendations 31 and 32 that further clarify the meaning of third-party effectiveness.]

Effectiveness of a security right that is not effective against third parties

31. The law should provide that a security right that has been created in accordance with the provisions of the law on creation is effective against the grantor even if it is not effective against third parties.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that a security right that is not effective against third parties has no effects as against general creditors or secured creditors whose security rights are not effective against third parties. This approach is consistent with the meaning of third-party effectiveness adopted in the Guide. The practical result of this approach is that no issue of priority arises in the case of security rights that are not effective against third parties and, therefore, such rights would be equal between them and with the rights of general creditors (unless they become judgement creditors, see recommendation 86).]

Continued effectiveness of a security right against third parties after a transfer of the encumbered asset

32. The law should provide that, except as provided in recommendations 82 to 84, after transfer of a right in an encumbered asset, a security right that is effective against third parties at the time of the transfer continues to encumber the asset and remains effective against third parties.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that this recommendation reflects the rule that the mere transfer of an encumbered asset does not make a security right ineffective against third parties (droit de suite). This rule is restated somewhat differently in recommendation 81. The Working Group may wish to consider whether the rule should be stated in this chapter or in the chapter on priority.]

General method for achieving third-party effectiveness of a security right

33. The law should provide that a security right created in accordance with the provisions of the law on creation is effective against third parties if a notice with respect to the security right is registered in the general security rights registry referred to in recommendations 55-71.

34. [The law should provide that registration of such a notice does not create a security right and is not necessary for the creation of a security right.]

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that registration of a notice of a security right is a pre-condition for it to become effective against third parties but does not create the security right, nor is it necessary to create a security right. Creation requires mainly an agreement between the parties as provided in the recommendations of the chapter on creation.]

Alternative methods for achieving third-party effectiveness of a security right

35. The law should provide that a security right may also be made effective against third parties by one of the following alternatives to registration methods:

(a) In tangibles, by transfer of possession of an encumbered asset, as provided in recommendations 40 and 48-50;

(b) [In consumer goods of a value less than [specify value] at the time of creation of the security right, automatically upon creation of a non-acquisition security right (for acquisition security rights in consumer goods, see recommendation 185), as provided in recommendation 41];

(c) In movable property subject to registration in a specialized registry or notation on a title certificate, by such registration or notation, as provided in recommendation 42;

(d) In proceeds, automatically by achieving third-party effectiveness with respect to the proceeds, as provided in recommendations 43 and 44;

(e) In a personal or property right securing payment or other performance of a receivable, negotiable instrument or other obligation, by achieving third-party effectiveness with respect to the receivable, negotiable instrument or other obligation, as provided in recommendation 45;

(f) In a right to payment of funds credited to a bank account, by control, as provided in recommendation 46;

(g) In attachments, by registration as provided in recommendations 51-53; and

(h) In a mass or product by achieving third-party effectiveness [in a tangible before it becomes part of a mass or product] [in the mass or product within a certain time period after the tangible becomes part of the mass or product], as provided in recommendation 54.

Exclusive method for achieving third-party effectiveness of a security right in proceeds under an independent undertaking

36. The law should provide that, except as provided in recommendation 45, a security right in drawing proceeds under an independent undertaking is made effective against third parties only by control, as provided in recommendation 47.

Different third-party effectiveness methods for different types of asset

37. The law should provide that different methods for achieving third-party effectiveness may be used for different items or kinds of encumbered assets, whether they are encumbered pursuant to the same security agreement or not.

Continuity in third-party effectiveness of a security right

38. The law should provide that third-party effectiveness of a security right is continuous notwithstanding a change in the method by which it is made effective against third parties, provided that there is no time when the security right is not effective against third parties.

[Note to the Working Group: The Working Group may wish to note that this recommendation makes no separate reference to registration (i.e. advance registration before creation), as, if there is a change in the method of third-party effectiveness before registration lapses, the security will have been created and thus made effective against third parties.]

Lapse in advance registration or third-party effectiveness of a security right

39. The law should provide that, if notice of a security right has been registered or made effective against third parties and subsequently there is a period at which the security right is neither registered nor effective against third parties, registration or third-party effectiveness may be re-established. In such a case, registration or third-party effectiveness dates from the earliest time thereafter at which the security right is either registered or made effective against third parties.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that reference is made in this recommendation to registration separately from third-party effectiveness as registration may be made before the creation of a security right (see recommendation 64), while third-party effectiveness requires creation of the security right and completion of a method of third-party effectiveness (see recommendation 31).]

The Working Group may wish to note that this recommendation tracks the language of recommendations 77 and 78, under which priority dates from the time when third-party effectiveness is re-established or a notice with respect to the security right is registered. The Working Group may wish to consider whether the first sentence of recommendation 39 should be retained in this chapter as it deals with the lapse of registration or third-party effectiveness and the second sentence should be reflected only in the chapter on priority as it essentially deals with priority.

The Working Group may also wish to note that the commentary will explain that third-party effectiveness may lapse where, for example, the secured creditor does not renew its registration before expiry of its initial term or where third-party effectiveness was obtained by delivery of possession of the encumbered assets to the secured creditor but the secured creditor later returns possession to the grantor. The commentary will also explain that third-party effectiveness does not lapse in such cases if the security right is registered or made effective against third parties before the lapse of the particular method of third-party effectiveness.

The commentary will include the following examples of situations where continuity in third-party effectiveness is preserved notwithstanding lapse in a particular method of third-party effectiveness:

(a) On day 1, the grantor creates a security right in favour of the secured creditor who on the same day takes possession of the encumbered assets. On day 2, the secured creditor registers a notice about its security right and then relinquishes possession. Third-party effectiveness is continuous from day 1;

(b) On day 1, the grantor creates a security right in favour of the secured creditor on day 1 who, on the same day, registers a notice of its security right. On day 2, the secured creditor takes possession of the encumbered assets while registration lapses on day 3. Third-party effectiveness is continuous from day 1. The result is the same if the secured creditor registers again on day 4 and surrenders possession of the encumbered assets to the grantor on day 5.]

Third-party effectiveness of a security right in tangibles by possession

40. The law should provide that a security right in tangibles may also be made effective against third parties through possession.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that, as the term “tangibles” covers negotiable instruments and negotiable documents (see definition (i)), this recommendation applies to third-party effectiveness of security rights in negotiable instruments and negotiable documents. As a result, a security right in a negotiable instrument or in a negotiable document may be made effective against third parties by registration or possession. Recommendations 48 to 50 add special rules with respect to third-party effectiveness of security rights in negotiable documents and goods covered by negotiable documents.]

[Third-party effectiveness of a non-acquisition security right in low-value consumer goods]

41. A non-acquisition security right in consumer goods of a value less than [specify value] at the time of creation of the security right (for acquisition security rights in consumer goods, see recommendation 185) that is not subject to a specialized registration or title certificate system is effective against third parties automatically upon creation of the security right.]

[Note to the Working Group: The Working Group may wish to note that, as there is no significant financing that involves non-acquisition security rights in consumer goods, there was broad support in the Commission at its thirty-ninth session for the deletion of recommendation 41 (and, therefore, recommendation 35, subparagraph (b); see A/61/17, para. 25). If this recommendation is retained, the Working Group may wish to consider that, as low value in one country may be high value in another country, the determination of low value should be based on a cost-benefit analysis that compares the potential realization value of an asset to the cost of registration.]

Third-party effectiveness of a security right in movables with respect to which there is a specialized registration or a title certificate system

42. The law should provide that a security right in movable property that is subject to registration in a specialized registry or notation on a title certificate under law other than this law may also be made effective against third parties by:

- (a) Registration in the specialized registry; or
- (b) Notation on the title certificate.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that registration in a specialized registry may have constitutive rather than third-party effects and may involve registration of documents rather than a mere notice. The commentary will also explain that recommendation 42 is formulated to avoid addressing that issue which is a matter for other law. In addition, the commentary will explain that registration in the general security rights registry and registration in the specialized registry are the only available methods for achieving third-party effectiveness of a security right in movable property of the kind referred to in this recommendation (i.e. third-party effectiveness may not be achieved by possession), if so provided in the relevant special legislation (for attachments subject to specialized registration, see recommendation 53).

The commentary will also explain that recommendation 42 is supplemented by recommendation 79, under which a security right registered in the specialized registry or with respect to which a notation was made in a title certificate has priority over a security right registered in the general security rights registry. Consequently, to ensure maximum priority over all classes of competing creditors, the security right should be made effective by registration in accordance with recommendation 42 rather than recommendation 33. This approach is justified by the need to preserve the reliability of the specialized registry or title certificate system for buyers of encumbered assets or secured creditors that rely on these systems to ensure protection of their rights.]

Third-party effectiveness of a security right in proceeds¹⁹

Alternative A

43. The law should provide that, if a security right in an encumbered asset is effective against third parties, a security right in any proceeds of the encumbered asset is effective against third parties when the proceeds arise, provided that:

- (a) The security right in the encumbered asset was made effective against third parties by registration of a notice in the general security rights registry, registration in a specialized registry or notation on a title certificate and remains effective at that time; or

[Note to the Working Group: The Working Group may wish to note that subparagraph (a) would not apply, for example, to a security right that was made effective against third parties by possession. The residual rule in recommendation 44 would apply to such a right. The Working Group may also wish

¹⁹ For recommendations 43 and 44, see A/CN.9/WG.VI/ WP.26/Add.4, recommendations 41 and 41 bis.

to note that, at its thirty-ninth session, the Commission referred the alternatives to the Working Group with a view to trying, to the extent possible, to reach agreement on one of them (see A/61/17, para. 26).]

(b) The proceeds are money, receivables, negotiable instruments or rights to payment of funds credited to a bank account.

44. If recommendation 43 does not apply, the security right in the proceeds is effective against third parties for [...] days after the proceeds arise and continuously thereafter, if it was made effective against third parties by one of the methods referred to in recommendation 33 or 35 before the expiry of that time period.

Alternative B

43. The law should provide that, if a security right in an encumbered asset is effective against third parties, a security right in any proceeds of the encumbered asset is effective against third parties when the proceeds arise, provided that the proceeds are money, receivables, negotiable instruments or rights to payment of funds credited to a bank account.

44. If recommendation 43 does not apply, the security right in the proceeds is effective against third parties for [...] days after the proceeds arise and continuously thereafter, if it was made effective against third parties by one of the methods referred to in recommendation 33 or 35 before the expiry of that time period.

[Note to the Working Group: The Working Group may wish to note that, in view of the difference of opinion in the Working Group as to whether the right in proceeds should be automatically effective or whether a separate act of third-party effectiveness should take place when the proceeds arose (see A/CN.9/593, paras. 26-32), recommendation 43 includes two alternatives.

Under alternative A, a security right in proceeds is automatically effective against third parties, if the security right in the originally encumbered assets was made effective against third parties by registration or if the security right was in money and the like. If the security right was made effective against third parties by possession, according to recommendation 44, the security right in the proceeds would be effective for a short period of time and thereafter only subject to a separate act of third-party effectiveness.

Under alternative B, automatic third-party effectiveness would be limited to proceeds in the form of money and the like, while recommendation 44 would apply to all other cases. As a result of this approach, a security right in proceeds would remain effective against third parties for a few days after the proceeds arose and thereafter only if a notice was registered with respect to the security right in the proceeds or by possession. The commentary will clarify that civil and natural fruits are automatically covered as they are defined as “proceeds” (see definition (jj)).

The Working Group may also wish to consider that, to balance the needs to protect a secured creditor and third parties, the time period referred to in recommendation 44 should be as short as the grace period in the third-party effectiveness recommendation applicable to acquisition security rights (i.e. 20-30 days, see recommendation 184).]

B. Asset-specific recommendations

Third-party effectiveness of a security right in a right that secures a receivable, negotiable instrument or any other obligation²⁰

45. The law should provide that, if a security right in a receivable, negotiable instrument or any other obligation covered as an encumbered asset by this law is effective against third parties, the security right is automatically effective against third parties with respect to any personal or property right that secures payment or performance of the receivable, negotiable instrument or other obligation, without further action by either the grantor or the secured creditor. If the personal or property right is an independent undertaking, a security right in the proceeds under the independent undertaking is automatically effective against third parties (but, as provided in recommendation 24, subparagraph (b), the security right does not extend to the right to draw under the independent undertaking). This recommendation does not apply to a right in immovable property that under law other than this law is transferable separately from a receivable, negotiable instrument or other obligation that it may secure.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that the general third-party effectiveness recommendations apply to security rights in receivables, as well as to outright transfers of receivables. The commentary will also explain that the language in parenthesis in the second sentence explains that the security right does not extend to the right to draw (i.e. to demand payment) under an independent undertaking. As there is no security right in the right to draw, there is no issue of third-party effectiveness in that regard.]

Third-party effectiveness of a security right in a right to payment of funds credited to a bank account²¹

46. The law should provide that a security right in a right to payment of funds credited to a bank account may also be made effective against third parties by the secured creditor obtaining control with respect to the right to payment of funds credited to the bank account.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that, pursuant to recommendation 33, a security right in a right to payment of funds credited to a bank account may also become effective against third parties by registration of a notice in the general security rights registry.]

Third party effectiveness of a security right in proceeds under an independent undertaking²²

47. The law should provide that, except as provided in recommendation 45, a security right in proceeds under an independent undertaking may be made effective against third parties only by the secured creditor obtaining control with respect to the proceeds under the independent undertaking.

²⁰ See A/CN.9/611, recommendation 37.

²¹ See A/CN.9/611/Add.1, recommendation 43.

²² See A/CN.9/611/Add.1, recommendation 49.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that neither possession of an independent undertaking nor registration of a notice should be a method of achieving third-party effectiveness of a security right in a right to proceeds under an independent undertaking. Possession of an independent undertaking (even when it is in tangible form) plays only a limited role in the modern use of independent undertakings. In addition, if possession were included in the Guide as a method of achieving effectiveness against third parties, there would be a need for complex rules dealing with priority and conflict of laws. It should be noted, however, that, although possession does not constitute a method of achieving effectiveness against third parties, as a practical matter, possession would give protection to a secured creditor when the terms of the independent undertaking require the physical presentation of the independent undertaking to make a draw under the independent undertaking. In such a circumstance, the beneficiary could not make an effective draw without the secured creditor's cooperation, so the secured creditor could take steps to assure itself of payment (e.g. the secured creditor could require the beneficiary to obtain an acknowledgement that would achieve control for the secured creditor before surrendering the independent undertaking and allowing it to be presented to the guarantor/issuer or nominated person that gave the acknowledgement).]

Third-party effectiveness of a security right in a negotiable document²³

48. The law should provide that a security right in a negotiable document may also be made effective against third parties by the secured creditor obtaining possession of the document.

49. The law should provide that, if a security right in a negotiable document is effective against third parties, the corresponding security right in the goods covered by the document is also effective against third parties. As long as a negotiable document covers goods, a security right in the goods may be made effective against third parties by the secured creditor obtaining possession of the document.

50. The law should provide that a security right in a negotiable document that was made effective against third parties by the secured creditor obtaining possession of the document remains effective against third parties for a short period of [to be specified] days after the negotiable document has been relinquished to the grantor or other person for the purpose of ultimate sale or exchange, loading or unloading, or otherwise dealing with the goods covered by the negotiable document.

Third-party effectiveness of a security right in attachments²⁴

51. The law should provide that, if a security right in a tangible is effective against third parties at the time when the tangible becomes an attachment, the security right remains effective against third parties thereafter.

52. The law should provide that a security right in an attachment to immovable property may also be made effective against third parties by registration in the immovable property registry.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that, in accordance with recommendation 33, a security

²³ See A/CN.9/611/Add.1, recommendations 44-44 ter.

²⁴ See A/CN.9/WG.VI/WP.26/Add.4, recommendations 45 and 46.

right in a tangible that is an attachment when the security right is made effective against third parties or becomes an attachment subsequently may be made effective against third parties by registration of a notice in the general security rights registry. The commentary will also explain that recommendation 51 is intended to clarify that no additional step is necessary to make effective against third parties a security right in an attachment that was effective against third parties before the tangible became an attachment. In addition, the commentary will explain that recommendation 52 makes it clear that a security right in an attachment to immovable property may be made effective against third parties by registration in the general security rights registry or in the immovable property registry.

This recommendation is designed to protect the integrity and reliability of the immovable property registry. It is supplemented by recommendation 99, pursuant to which a security right in attachments to immovable property made effective against third parties in accordance with immovable property law has priority over a security right in such attachment made effective against third parties in accordance with this law. Recommendation 52 is also supplemented by recommendation 100, pursuant to which a security right in attachments to immovable property, which became effective against third parties by registration in the immovable property registry under recommendation 52 has priority over a security right in the related immovable that was registered subsequently. The commentary will also explain that, if a security right in an attachment to immovable property is made effective against third parties under this recommendation, what is registered is, in principle, a matter of immovable property law. However, the attention of the legislator may have to be drawn to the need to amend immovable property law so as to permit registration of a notice about a security right rather than only notarial documents. One difficulty in third parties finding that notice is that registration in the immovable property registry is made against the asset and not the grantor.

The commentary will further explain that the security right will be in the immovable property as a whole but the notice should describe the attachment and priority should be limited to the value of the attachment, if it were detached. The question whether the attachment could be detached and how the secured creditor would be paid would also need to be addressed as a matter of enforcement (see recommendation 170). The Working Group may wish to consider whether a creditor with a right acquired under immovable property law should have a right to pay off the debt owed to the secured creditor with a security right acquired under movable property law. This matter may be left to inter-creditor agreements.

The commentary will also discuss approaches taken in recent legislation under which a security right in an attachment is registered only in the general security rights registry and the registry forwards a notice of such registration to the immovable registry.]

Third-party effectiveness of a security or other right in attachments to movable property subject to a specialized registration system or title certificate system²⁵

53. The law should provide that a security right in an attachment to movable property that is subject to registration in specialized registry or notation on a title certificate under law other than this law may also be made effective against third parties by:

²⁵ See A/CN.9/WG.VI/WP.26/Add.4, recommendation 46 bis.

- (a) Registration in the specialized registry; or
- (b) Notation on the title certificate.

[Note to the Working Group: The Working Group may wish to note that this recommendation tracks the language of recommendation 42.]

Third party effectiveness of a security right in a mass or product²⁶

Alternative A

54. The law should provide that, if a security right in a tangible is effective against third parties when it becomes part of a mass or product, the security right in the mass or product created under this law as provided in recommendation 29 is effective against third parties thereafter without the need for any further act.

Alternative B

54. The law should provide that, if a security right in a tangible is effective against third parties when it becomes part of a mass or product, the security right in the mass or product created under this law as provided in recommendation 29 is effective against third parties thereafter for [...] days after the mass or product is created. The security right remains effective against third parties thereafter if it is made effective against third parties by one of the methods referred to in recommendation 33 or 35 before the expiry of that time period.

VI. The registry system²⁷

Purpose

The purpose of the provisions of the law on the registry system is to establish a general security rights registry and to regulate its operation. The purpose of the registry system is to provide:

- (a) A method by which an existing or future security right in a grantor's existing or future assets may be made effective against third parties;
- (b) A basis for priority rules that depend on the time when third-party effectiveness of a security right is achieved; and
- (c) An objective source of information for third parties dealing with a grantor's assets (such as prospective secured creditors and buyers, judgement creditors and the grantor's insolvency representative) as to whether the assets may be encumbered by a security right.

The registry system should be designed to ensure that the registration and searching process is simple, time- and cost-efficient, user-friendly and publicly accessible.

[Note to the Working Group: The Working Group may wish to note that the commentary will relate the purpose section of this chapter to recommendations 12 and 13 (creation), 30 (distinguishing creation from third-party effectiveness),

²⁶ See A/CN.9/WG.VI/WP.26/Add.4, recommendation 47.

²⁷ See A/CN.9/WG.VI/WP.26/Add.5.

34 (making the point that registration does not create a security right), 42 (registration in a specialized registry) and 64 (making the point that registration may take place before creation of a security right).

The commentary will also explain that registry systems that: (a) require registration of documents (rather than of a notice as provided in recommendation 55, subparagraph (b) and 58); (b) require scrutiny or verification of the documents (rather than no scrutiny or verification by anybody other than the registrant as provided in recommendation 55, subparagraph (c)); (c) have constitutive effects (rather than the effects described in recommendation 33 or 35); and (c) require high (e.g. ad valorem) registration fees (rather than nominal fees based on cost recovery as provided in recommendation 55, subparagraph (h)) are not suitable for a speedy, efficient, inexpensive and user-friendly registry, which is crucial for a secured transactions law in movable property that promotes increased access to lower-cost credit.]

Operational framework of the registration and searching process

55. The law should provide an administrative framework to ensure that the registration and searching process operates as follows:

(a) Clear and concise guides to registration and searching procedures are widely available and information about the existence and role of the registry is widely disseminated;

(b) Registration is effected by registering a notice, containing the information specified in recommendation 58, as opposed to a copy of the underlying security agreement or other document;

(c) A notice may be registered without verification or scrutiny by anybody other than the registrant;

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that false or misleading notices could be cancelled under recommendation 68, while the question whether any penalties for knowingly registering a false or misleading notice should be imposed is left to tort, penal or other law. The commentary will also provide guidance as to types of possible penalty.]

(d) A search may be made without the need for the searcher to justify the reasons for the search;

(e) The record of the registry is centralized and contains all notices of security rights registered under this law;

(f) Notices are indexed and can be retrieved by searchers according to the name of the grantor or according to some other reliable identifier of the grantor, such as State-issued identification or commercial registration number;

(g) The registry is open to the public;

(h) Fees for registration and searching are set at a level no higher than necessary to permit cost recovery;

(i) Registrants may choose among multiple modes and points of access to the registry;

(j) The registry operates reliable and consistent service hours compatible with the needs of potential registry users; and

(k) To the extent the infrastructural capacity of the State permits, the registration system is computer-based. In particular,

(i) Notices are stored in electronic form in a computer database;

(ii) Registrants and searchers have immediate access to the registry record by electronic or similar means, including Internet and electronic data interchange;

(iii) The system is programmed to minimize the risk of entry of incomplete or irrelevant information (e.g. by requiring essential data fields to be completed); and

(iv) The system is programmed to facilitate speedy and complete retrieval of information and to minimize the practical consequences of human error.

Security and integrity of the registry

56. In order to ensure the security and integrity of the registry record, the operational and legal framework of the registry should reflect the following characteristics:

(a) A registrant can obtain a record of the registration as soon as the registration information is entered into the registry record;

(b) The identity of a registrant is requested and entered into the registry record;

(c) [The registry] [The secured creditor] is obligated to forward a copy of a notice to the grantor named in the notice;

(d) The registry is obligated to send a copy of any changes to a notice to the secured creditor named in the notice;

(e) Although the day-to-day operation of the registry may be delegated to a private authority, the State retains the responsibility to ensure that it is operated in accordance with the governing legal framework; and

(f) The registry record can be reconstructed.

Responsibility for loss or damage

57. The law should provide for the allocation of responsibility for loss or damage caused by an error in the administration or operation of the registration and searching system. If the system is designed to permit direct registration and searching by registry users without the intervention of registry personnel, the responsibility of the registry should be limited to a system malfunction.

Required content of notice

58. The law should provide that the notice must contain only:

(a) The identity of the grantor, as provided in recommendations 59-61, and the secured creditor or its representative and their addresses;

(b) A description of the asset covered by the notice as provided in recommendation 63;

(c) The duration of the registration as provided in recommendation 64; and

[(d) A statement of the maximum monetary amount for which the security right may be enforced [if the State determines that such information is helpful to facilitate subordinate lending.]]

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that, while the meaning of the term “representative” may be subject to law other than this law, it includes agent, trustee or other person acting on behalf or in favour of the secured creditor.]

Sufficiency of grantor identifier

59. The law should provide that a notice is effective only if it states the grantor’s correct identifier or, in the case of an incorrect statement, if the notice can be retrieved by searching the registry record according to the correct identifier.

60. The law should provide that, where the grantor is a natural person, the identifier of the grantor for the purposes of effective registration is the grantor’s name, as it appears in a specified official document, such as a birth certificate, identity card or passport. Where necessary, additional information, such as the birth date or identity card number, should be required to uniquely identify the grantor.

61. The law should provide that, where the grantor is a legal entity, the grantor’s identifier for the purposes of effective registration is the name that appears in the documents constituting the entity.

[Note to the Working Group: The Working Group may wish to note that the commentary will clarify that where the name of the grantor is listed in a separate record maintained by the State, for example, a commercial or company register, the State may wish to set up links between the two registers to facilitate accurate data entry. The commentary will also explain that an identifier other than the name (e.g. birth date) is required for natural persons to distinguish between natural persons with the same name. Such identifier is not required for corporations as their name has to be unique to be accepted by the company registry.]

Change of the grantor’s identifier

62. The law should provide that, if the identifier of the grantor used in the notice changes after the notice is registered:

(a) A security right in an encumbered asset in which the grantor has rights at the time of the change remains effective against third parties;

(b) A security right in an asset acquired by the grantor or created within [...] days after the time of the change is effective against third parties; and

(c) A security right in an asset acquired by the grantor or created more than [...] days after the time of the change is not effective against third parties unless the notice is amended to provide the new identifier of the grantor.

[Note to the Working Group: The Working Group may wish to consider the following alternatives to recommendation 62:]

“Alternative A

The law should provide that, if the identifier of the grantor changes after a notice is registered, the security right remains effective against third parties until the grantor notifies the secured creditor of the name change. The secured creditor then has [...] days to amend the notice. Failure to do so means that the security right is ineffective against secured creditors that register and buyers that acquire a right in the encumbered asset after the expiry of the time period, unless the secured creditor amends the notice before the competing security right is registered or the buyer acquires a right in the asset.

Alternative B

The law should provide that, if the identifier of the grantor changes after a notice is registered, the secured creditor has [...] days to amend the notice. Failure to do so means that the security right is ineffective against secured creditors that register and buyers that acquire a right in the encumbered asset after the expiry of [...] days from the time of the change, unless the secured creditor amends the notice before the competing security right is registered or the buyer acquires a right in the asset.”

In addition, the Working Group may wish to note that the commentary will provide guidance as to the length of the time period referred to in recommendation 62 (e.g. 60, 90 or 120 days). The commentary will also discuss various circumstances in which an entity may change its name (e.g. merger or acquisition).]

Sufficiency of description of assets covered by a notice

63. The law should provide that a description of the assets covered by a notice is sufficient if it identifies the assets covered by the notice in a manner that distinguishes those assets separately from other assets of the grantor. A generic description of the encumbered assets is sufficient.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that descriptions such as “all inventory” or “all present and future assets” would be sufficient.]

Time of registration

64. The law should provide that a notice with respect to a security right may be registered before or after creation of the security right.

[Note to the Working Group: The Working Group may wish to note that the purpose of this recommendation is to confirm that registration may take place before creation of the security right. The commentary will explain that the purpose of allowing advance registration is to enable secured creditors to ensure their priority position by registering (especially as against potential competing claimants) at the earliest time possible in order to facilitate the extension of credit upon conclusion of the formal security agreement (see also recommendation 76, according to which priority dates back from the time of registration (i.e. before creation of a security right, assuming that a security right comes into existence subsequently) or at the time of third-party effectiveness (i.e. creation plus registration or possession). The commentary will also explain that the grantor is not affected by inaccurate or false notices as they do not produce any legal consequences and, in any case, the debtor may always seek a cancellation of the

notice under recommendation 68 or exercise other remedies under tort, penal or other law.]

One notice for multiple security agreements between the same parties

65. The law should provide that registration of a single notice is sufficient to ensure the third-party effectiveness of security rights created or to be created by all security agreements entered into between the same parties to the extent they cover items or kinds of movable property that fall within the description contained in the notice.

Duration and extension of notice

66. The law should specify the duration of a notice or else permit the registrant to select the duration of a notice at the time of registration and extend it at any time before its expiry.

Time of effectiveness of notice or amendment

67. The law should provide that a notice or its amendment takes effect when the information contained in the notice or its amendment is entered into the registry record so as to be available to searchers of the registry record.

[Note to the Working Group: The Working Group may wish to note that, if the registration system permits the submission of paper notices to the registry (as opposed to direct data entry by registrants), there will be some delay between receipt of the notice by the registrar and the time the information on the notice is entered into the record by registry staff so as to become available to searchers. In such circumstances, the question arises as to the time when the registration should be effective, the time of receipt of the notice at the registry or the time the notice is entered into the record and becomes available to searchers. If the registration is effective when received by the registrar, a search will not disclose all legally effective registrations. To protect the information needs of third parties, therefore, this recommendation makes the time of registration concomitant with searchability. Although this puts the risk associated with any delay on the secured creditor, the secured creditor is in a better position to take steps to protect itself than third parties. Moreover, the recommendations earlier outlined on the design and operation of the registry should ensure speedy and efficient registration procedures. In a fully electronic system that requires no intervention by registry staff, entry of the notice and its availability to searchers is virtually simultaneous and this problem is significantly reduced.]

The Working Group may also wish to note that the commentary will explain that an amendment may involve various changes, such as: (a) adding or deleting items or kinds of encumbered assets; (b) adding or deleting the identifier of a grantor; (c) recording a change in the identifier of a grantor or secured creditor; (d) disclosing an assignment of the security right by the secured creditor named in the original registration to a new secured creditor; or (e) disclosing a subordination agreement or undertaking that affects a registered security right.]

Cancellation or amendment of notice

68. The law should provide that, if no security agreement has been completed, the security right has been terminated [by full payment or otherwise] or the notice contains information not authorized by the grantor:

(a) The secured creditor must cancel or amend the notice within [...] days after the written request of the grantor;

(b) The grantor is entitled to compel cancellation or amendment of the notice through a summary procedure;

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that the grantor may seek to cancel the notice under subparagraph (b) even before expiry of the period referred to in subparagraph (a). In such a case, however, the grantor may have to bear any costs involved (see A/CN.9/593, para. 54). The Working Group may also wish to note that the commentary will provide guidance to States as to the length of the time period referred to in this recommendation (e.g. 20-30 days).]

69. The law should provide that the secured creditor is entitled to cancel or amend a notice at any time.

70. The law should provide that, where a notice has been cancelled, the record of the notice should be removed from the searchable records of the registry within a short time after its cancellation. However, the information in the cancelled notice and the fact of the cancellation should be archived so as to be capable of retrieval if necessary.

71. [The law should provide that, in the case of an assignment of the secured obligation, [the notice may be amended to indicate the name of the new secured creditor but the unamended notice remains effective] [to remain effective, the notice must be amended to indicate the name of the new secured creditor].]

[Note to the Working Group: The Working Group may wish to consider which of the alternatives reflected in this recommendation within square brackets is preferable (see A/CN.9/593, para. 56).]

VII. Priority of a security right as against the rights of competing claimants²⁸

Purpose

The purpose of the provisions of the law on priority is to:

(a) Provide an efficient and predictable regime to determine the order of priority of a security right as against the rights of all possible competing claimants; and

(b) Facilitate transactions by which a grantor may create more than one security right in the same asset and thereby use the full value of its assets to obtain credit.

²⁸ See A/CN.9/WG.VI/WP.26/Add.6.

A. General recommendations

Extent of priority

72. The law should provide that the priority of a security right extends to all obligations secured under the security agreement [up to the maximum monetary amount indicated in the notice].

Irrelevance of knowledge of the existence of the security right

73. The law should provide that knowledge of the existence of a security right on the part of a competing claimant does not affect its rights under the provisions of the law on priority.

Priority of security rights securing future obligations

74. [Subject to recommendation 86,] the priority of a security right does not depend on the date when the secured obligation was incurred.

[Note to the Working Group: The Working Group may wish to note that the commentary will clarify that if a security right securing a credit facility is made effective against third parties on day 1 and credit is extended on day 2 and then on day 3 and 4, priority dates back from the time the security right was made effective against third parties (i.e. day 1). The commentary will also explain that an exception to this rule is stated in recommendation 86, which provides that, if the secured obligation was incurred after a judgement creditor acquires rights in the encumbered asset, the security right is subordinate to the rights of the judgement creditor. The Working Group may wish to consider whether further exceptions should be introduced (e.g. the super-priority of an acquisition security right should be limited to secured obligations incurred up to the time of the acquisition of the relevant assets by the transferee).]

Subordination agreements

75. The law should provide that a competing claimant entitled to priority may at any time subordinate its priority unilaterally or by agreement in favour of any other existing or future competing claimant.

[Note to the Working Group: The Working Group may wish to note that the commentary will make clear that, under this recommendation, a subordination agreement would be possible not only between competing claimants with a different priority ranking but also between competing claimants with the same priority ranking (see A/CN.9/593, para. 61). The Working Group may also wish to note that subordination agreements in the case of the grantor's insolvency are addressed in recommendation 179.]

Priority between security rights in the same encumbered assets

76. The law should provide that, except as provided in recommendations [...], a security right in movable property registered or made effective against third parties, whichever occurs first, has priority over a security right in the same property subsequently registered or that is made effective against third parties. The date of registration determines priority of a security right with respect to all encumbered

assets irrespective of whether they are acquired by the grantor or come into existence before, on or after the date of registration.

[Note to the Working Group: The Working Group may wish to note that the commentary will make clear that the reference to registration means registration before creation of a security right pursuant to recommendation 64, while the reference to third party effectiveness means creation plus a step to achieve third party effectiveness pursuant to recommendation 33, 35 or 36. The commentary will also explain that issues of priority arise where there are competing rights in the same assets, the debtor defaults on the secured obligation and the value of the encumbered assets is not sufficient to satisfy all secured obligations. The commentary will also make clear that:

- (a) As between two security rights registered in the general security rights registry, the first registered wins;*
- (b) As between two security rights registered in a specialized registry or noted on a title certificate, the first registered wins;*
- (c) As between a security right registered in the general security rights registry and a security right registered in a specialized registry or noted on a title certificate, the latter wins (as a result of recommendation 79); and*
- (d) As between a security right registered (in advance of creation) in the general security rights registry or in a specialized registry or noted on a title certificate and a security right (created and) made effective against third parties, the first registered or made effective against third parties wins.*

In addition, the Working Group may wish to note that the commentary will also clarify that, if a security right is not effective against third parties, no issue of priority arises and, therefore, such security rights have the same ranking. The commentary will also explain that recommendation 76 applies to a conflict between two security rights in the same encumbered assets (as to whether it should apply to conflicts with a buyers and judgement creditor; see note to recommendation 82).

Moreover, the Working Group may wish to note that the commentary will also explain that the reasons why a security right registered in advance of its creation is given priority as of the time of registration are to encourage advance registration (which provides notice to third parties) and to provide certainty to secured creditors by enabling them to determine the priority of their security rights before they extend credit. This reason does not apply to advance possession. Furthermore, such a rule would not be necessary with respect to negotiable instruments and negotiable documents, since possession of them gives a superior right than is obtained by registration (see recommendations 89, 90, 97 and 98). As to other tangibles, the assumption is that advance possession is not practised (delivery of possession will always be based on an agreement about the security right). Accordingly, no general rule along the lines of recommendation 76 is introduced with respect to advance possession. The Working Group may wish to consider whether there are substantial financing practices in which the secured creditor may take possession of the encumbered assets in advance of such agreement and, if so, whether the secured creditor that took advance possession should have priority as of that time (see A/CN.9/593, para. 68).]

Continuity in priority

77. The law should provide that the priority of a security right is not affected by a change in the method by which it is made effective against third parties, provided that there is no time when the security right is not effective against third parties.

78. The law should provide that, if a security right has been registered or made effective against third parties and subsequently there is a period during which the security right is neither registered nor effective against third parties, the priority of that security right dates from the earliest time thereafter at which the security right is either registered or made effective against third parties.

[Note to the Working Group: The Working Group may wish to note that, under recommendation 39, third-party effectiveness is continuous. If it lapses, it dates back from the time it was re-established (see also examples set forth in the note to recommendation 39).]

Priority of a security or other right registered in a specialized registry or noted on a title certificate

79. The law should provide that a security right or other right (such as the right of a buyer or lessor) in movable property other than attachments that is made effective against third parties as provided in recommendation 42 has priority over:

(a) A security right in the same asset with respect to which a notice is registered in the general security rights registry or which is made effective against third parties by any other method regardless of the order; and

(b) A security right that is subsequently registered in the specialized registry or noted on a title certificate.

Priority of a security right in proceeds²⁹

80. Except as provided in recommendations [...], the law should provide that a security right in the proceeds of an encumbered asset that is effective against third parties has the same priority as the security right in the encumbered asset.

Rights of buyers, lessees and licensees of encumbered assets

81. The law should provide that, if a security right is effective against third parties, the security right continues in the encumbered assets in the hands of a third party except as provided in recommendations 82, 83 and 84.

[Note to the Working Group: The Working Group may wish to note that this recommendation is designed to state the rule that the secured creditor may follow the asset in the hands of a transferee (droit de suite, a rule stated somewhat differently in recommendation 32).]

82. The law should provide that:

(a) A security right does not continue in an encumbered asset that the grantor sells or otherwise disposes of, if [:

(i)] The secured creditor authorizes the sale or other disposition free of the security right [; or

²⁹ See A/CN.9/WG.VI/WP.26/Add.4, recommendation 67.

- (ii) In the case of a security right registered before creation, the secured creditor has knowledge of the sale]; and
- (b) The rights of a lessee or licensee of an encumbered asset are not affected by a security right if [
 - (i)] The secured creditor authorizes the grantor to lease or license the asset [unaffected by the security right] [; or
 - (ii) In the case of a security right registered before creation, the secured creditor has knowledge of the lease or licence.]

[Note to the Working Group: The Working Group may wish to note that the formulation of subparagraph (b) of this recommendation has been changed to address a concern expressed at the thirty-ninth session of the Commission (see A/61/17, para. 37; for the same reason, similar changes were made to the formulation of recommendations 83, subparagraphs (b) and (c), and 84, second sentence) and the matter is addressed in the following paragraphs of this note.]

Under recommendation 76, registration of a notice before the creation of a security right gives priority over another security right that was (created and) made effective against third parties later. The Working Group may wish to consider whether this recommendation should apply to priority conflicts between a secured creditor and a buyer, lessee or licensee of encumbered assets acquiring a right in the assets after registration of a notice but before actual creation of a security right in them. It may be considered that the buyer, lessee or licensee should take free of the security right in these circumstances on the basis that by the time the security right is created, the encumbered assets are no longer owned by the seller or are subject to the possession or use rights of the lessee or licensee. The disadvantage of such an approach would be that the secured creditor would then be able to rely on its act of advance registration to preserve priority only as against other secured creditors. As against intervening transferees, the secured creditor would have to undertake further inquiries before being able to safely advance credit once the security right comes into existence.

A similar issue arises when a judgement creditor acquires rights in the encumbered assets after advance notice of a security right is registered but before the security right is actually created. The considerations are somewhat different in this case, since a secured creditor is not subordinated to the rights of the judgement creditor, under the recommendations in this chapter, until it acquires actual knowledge of the judgement creditor's rights and is then subordinated for advances made after receiving knowledge. Consequently, if the security right has not yet been created when the judgement creditor advises the secured creditor of its intervening rights, the secured creditor can protect itself either by requiring the grantor to discharge the judgement or by reducing the credit the secured creditor plans to extend. A similar rule could be adopted for intervening buyers. Under this approach, a buyer, lessee or licensee of assets would take free of a prior-registered security right that has not yet come into existence provided the secured creditor had knowledge of the sale, lease or licence. Buyers, lessees and licensees could then protect themselves by giving notice of their transaction rather than having to secure a positive waiver of priority from the secured creditor. The secured creditor would likewise be protected because it would have actual knowledge of the intervening transaction before entering into the security agreement. The language included in

square brackets in subparagraphs (a) (ii) and (b) (ii) are intended to address this point.

The Working Group may also wish to note that application of the rule in recommendation 82 requires a comparison of the date at which a security right was made effective against third parties with the date of the sale, lease or licence of the encumbered asset (as a security right that was not effective against third parties would not produce effects as against buyers, lessees or licensees). While the date at which the security right was made effective against third parties will usually be obvious (inasmuch as the registry's records will reveal when a notice was registered), it may not be clear when a sale has taken place. For example, a contract to sell goods that are encumbered assets may have been entered into between the grantor/seller and the buyer on date 1, they may have been shipped to the buyer on date 2 (either because the contract provided for shipment on that date or otherwise), the goods may have been received by the buyer on date 3 and the buyer may have paid for them on date 4; under applicable law, the sale by the grantor/seller to the buyer may have occurred on any of those dates or on still another date. Application of the rule in recommendation 82 requires knowing which of those dates is the date on which the sale took place because the date that the security right was made effective against third parties might precede some but not all of those dates. The Working Group may thus wish to consider whether recommendation 82 (or the commentary accompanying it) should provide additional guidance as to when a sale should be considered to have taken place for purposes of determining the status of the buyer's rights to the goods as against the secured creditor. The commentary will also make clear that, if the grantor of an asset sells it with a retention of title, the buyer takes free of the retention of title when it pays the price. Before that, the retention-of-title seller has the rights of an owner (or secured creditor, depending on whether a unitary or a non-unitary approach is followed).]

83. The law should also provide that:

(a) A buyer in the ordinary course of business [and a buyer of consumer goods] takes free of a security right;

(b) The rights of a lessee in the ordinary course of business are not affected by a security right; and

(c) The rights of a licensee in the ordinary course of business under a non-exclusive license are not affected by a security right.

[Note to the Working Group: The Working Group may wish to note that, according to definition (uu), "buyer in the ordinary course of business" is a buyer of inventory in the ordinary course of business that has no knowledge that the sale violates a security or other right. The Working Group may also wish to recommend that buyers of consumer goods [of low value] that have no knowledge of a security right in the goods should take free of a security right in the goods. In that connection, the Working Group may wish to take into account that such buyer would have no way of finding out about the existence of a security right in the goods as, under recommendations 41 and 185, non-acquisition security rights in low-value consumer goods and acquisition security rights in consumer goods are exempt from registration (see A/CN.9/593, para. 77). With respect to paragraphs (b) and (c), the commentary will explain that the security right does not cease to exist but that, for the duration of the lease or license, the right of the secured creditor was limited to the lessor's or licensor's interest.]

84. The law should provide that, where a buyer or transferee acquires an encumbered asset free of a security right, any person that subsequently acquires a right in that asset from that buyer or transferee also takes free of the security right. Where the rights of a lessee or licensee are not affected by a security right, the rights of a sublessee or sublicensee are also unaffected by the security right.

Priority of preferential claims

85. The law should limit, both in number and amount, preferential claims arising by operation of law that have priority over security rights and, to the extent preferential claims exist, they should be described in the law in a clear and specific way.

[Note to the Working Group: The Working Group may wish to consider whether buyers, lessees and licensees should take free of any preferential claims. As this question does not involve a priority conflict with a security right, it may be addressed in the commentary.]

Priority of rights of judgement creditors

86. The law should provide that [, except as provided in recommendation 188,] a security right has priority over the rights of an unsecured creditor, provided that it was made effective against third parties before the unsecured creditor [, under law other than this law,] obtained a judgement or provisional court order against the grantor and took the steps necessary to acquire rights in assets of the grantor by reason of the judgement or provisional court order. The priority of the security right extends to credit extended by the secured creditor within a specified period of days after the unsecured creditor notified the secured creditor of the existence of the unsecured creditor's rights in the assets but does not extend to credit extended after the expiry of that period.

[Note to the Working Group: The Working Group may wish to consider: (a) whether it is possible for a security right in a particular asset to become effective against third parties at the same time that an unsecured creditor acquires, by reason of judgement or provisional court order, a right in that asset; and (b) if so, which of those rights has priority over the other.

The problem is most important in the case of a security right in future assets of a grantor. The Working Group may wish to consider the following example. A secured creditor takes a security right in all present and future assets of the grantor and advances credit to the grantor. The secured creditor registers a notice that covers present and future assets. Subsequently, under law other than the secured transactions law, an unsecured creditor of the grantor obtains a judgement or provisional court order entitling the unsecured creditor to a right in the grantor's present and future assets. Still later, the grantor buys and receives delivery of new assets. At that moment, the grantor acquires rights in those assets and the security right in those assets is created and, because of the earlier registration of the notice, the security right is immediately effective against third parties. At the same time, the unsecured creditor obtains a right in those goods because of the previously granted judgement or provisional court order providing for such a right. The current draft of recommendation 86 provides that the unsecured creditor's right has priority over the security right of the secured creditor.

The Working Group may wish to consider whether in such cases the secured creditor should have priority rather than the judgement creditor. This result would seem to further the goals of the Guide in creating greater certainty for the secured creditor with a view to making more credit available at lower cost. The result could be easily accomplished, without extensive redrafting, by adding in the first sentence of recommendation 86 the words “at the same time as or” immediately prior to the words “before the enforcing unsecured creditor”.

The Working Group may also wish to consider whether an exception to this recommendation should be introduced for acquisition security rights that are made effective against third parties within the relevant grace period (see recommendation 184). Acquisition security rights that are made effective against third parties during the relevant grace period should not lose to a judgement creditor described in this recommendation whose right in the encumbered asset arose after the creation of the security right but before it was made effective against third parties. If this were not the case, utilizing the grace period would be too risky for acquisition financiers.

In addition, the Working Group may wish to note that the commentary will explain that the priority under recommendation 84 does not extend to credit committed but not extended before the judgement creditor took the necessary steps to acquire rights in the encumbered assets. This approach is based on the assumption that the judgement will be an event of default under the credit facility enabling the secured creditor to cease extending any credit.

The commentary will also explain the implications of this recommendation for certain practices in which the credit facility does not provide for an event of default, such as a commitment consisting of an independent undertaking where the issuer may not revoke the independent undertaking if it does not permit revocation as a result of a judgement against assets securing the grantor’s obligation to reimburse the issuer for a payment under the independent undertaking.

Furthermore, the commentary will explain that, if the priority were to be limited to an amount mentioned in the notice registered, the issue might be resolved since the remaining assets of the grantor would be available for the payment of claims of unsecured creditors (see A/CN.9/593, paras. 80-82). The commentary will also give guidance as to the length of the time period referred to in this recommendation.]

Priority of rights of persons adding or preserving value of encumbered assets

87. If law other than this law gives rights equivalent to security rights to a creditor that has added value to goods (e.g. by repairing them) or preserved the value of goods (e.g. by storing or transporting them), such rights are limited to the goods, whose value has been improved or preserved and which are in the possession of that creditor, up to the value so added or preserved, and have priority over pre-existing security rights in the goods.

[Note to the Working Group: The Working Group may wish to note that limiting the priority given to storage and repair claims over security rights by reference to the extent to which they add to or preserve the value of the encumbered assets may give rise to a difficult and costly evidentiary burden for repairers, storers or transporters. The Working Group may wish to consider referring instead to the value (or the reasonable value) of the repair, transport or storage services rendered

in respect of the encumbered assets. Alternatively, reference could be made to the reasonable expenses of the repairer, storer or transporter. These formulations would still ensure that the priority of the repairer, storer or transporter is limited to services rendered with respect to the encumbered assets while avoiding difficult questions of proof as to the relative value of the encumbered assets before and after the services are rendered.]

Priority of a supplier's reclamation claim

88. If law other than this law provides that suppliers of goods have the right to reclaim the goods, the law should provide that the right to reclaim the goods is subordinate to security rights in such goods.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that this recommendation establishes a commercial law rule designed to accord priority to secured creditors over reclamation claims. Reclamation claims may arise by operation of law upon default or financial insolvency of the grantor. If an insolvency proceeding has commenced, applicable insolvency law will determine the extent to which the secured creditors and the reclamation claimants would be stayed or their rights would otherwise be affected (see recommendations 39-51 of the UNCITRAL Insolvency Guide). However, the priority rule established by this recommendation would be unaffected by the insolvency proceeding as provided in recommendation 179. The commentary will also explain, for the benefit of States that do adopt a non-unitary approach, that the reclamation claim does not include retention of title.]

Priority of a security right in insolvency proceedings

[Note to the Working Group: See recommendation 178 in the insolvency chapter.]

B. Asset-specific recommendations

Priority of a security right in a receivable³⁰

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that the general priority recommendations apply to security rights in receivables as well as to outright transfers of receivables.]

Priority of a security right in a negotiable instrument³¹

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that the general priority recommendations apply to priority with respect to security rights in negotiable instruments, while recommendations 89 and 90 deal with additional priority conflicts.]

89. The law should provide that a security right in a negotiable instrument that is made effective against third parties by possession of the instrument has priority over a security right in a negotiable instrument that is made effective against third parties by any other method.

³⁰ See A/CN.9/611.

³¹ For recommendations 90 and 91, see A/CN.9/611/Add.1, recommendations 74 and 74 bis.

90. The law should provide that a security right in a negotiable instrument that is made effective against third parties by a method other than possession of the instrument is subordinate to the rights of a secured creditor, buyer or other transferee (in a consensual transaction) that:

(a) Qualifies as a protected holder under the law governing negotiable instruments; or

(b) Takes possession of the negotiable instrument and gives value in good faith and without knowledge that the transfer is in violation of the rights of the secured creditor under the security agreement.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that, to preserve the unfettered negotiability of instruments, knowledge of the existence of a security right on the part of a transferee of an instrument does not mean, by itself, that the transferee did not act in good faith.]

91. [...]

Priority of a security right in a right to payment of funds credited to a bank account³²

92. The law should provide that a security right in a right to payment of funds credited to a bank account, which is made effective against third parties by control, has priority over a competing security right, which is made effective against third parties by any other method. If a depositary bank concludes control agreements with more than one secured creditor, priority among those secured creditors is determined according to the order in which the control agreements were concluded. If the secured creditor is the depositary bank, its security right has priority over any other security right (including a security right made effective against third parties by a control agreement with the depositary bank even if the depositary bank's security right is later in time) other than a security right of a secured creditor that has acquired control by becoming the account holder.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that third-party effectiveness of a security right in a right to payment of funds credited to a bank account may be achieved by either registration or control. If the security right is effective against third parties, it is effective against and has priority over a competing claimant (e.g. an insolvency representative or a later in time secured creditor). The commentary will also explain that control has an added priority benefit in that the secured creditor not only achieves effectiveness against third parties but it also has priority over an earlier secured creditor whose security interest is effective against third parties by a method other than control.]

In addition, the commentary will explain that a security right of the depositary bank always has priority even over a security right with respect to which the depositary bank has earlier entered into a control agreement because: (a) a security right of the depositary bank should have the same priority as its set-off right, which always has priority; (b) if the depositary bank's security right had no priority, the bank would not enter into any control agreement; and (c) a secured creditor could

³² For recommendations 93-95, see A/CN.9/611/Add.1, recommendations 76-78.

always seek to obtain a subordination agreement from the depositary bank. The commentary will also explain that, depending on the terms of the control agreement, the depositary bank may have a contractual obligation to a secured creditor with a control agreement even though the secured creditor might not have priority.

The Working Group may wish to recall that, at its tenth session, it had agreed that tracing of funds credited to a bank account would be discussed together with the issue of tracing of proceeds (see A/CN.9/603, para. 67). The Working Group may wish to deal with that issue as an issue of priority. The commentary to this recommendation will make clear that, if a secured creditor has control of a right to payment of funds credited to a bank account, its security right has priority over a security right in cash proceeds of an encumbered asset of another secured creditor that are credited to the same bank account, even if the other secured creditor is able to trace proceeds to the bank account. This is the case even if the competing security right became effective against third parties earlier than the security right held by the secured creditor with control.]

93. The law should provide that any right of the depositary bank to set off obligations owed to the depositary bank by the grantor against the grantor's right to payment of funds credited to a bank account has priority over the security right of any secured creditor other than a secured creditor that has acquired control by becoming the account holder.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that recommendations 92 and 93 mean that third parties are taken to know that they cannot rely on a right to payment of funds credited to a bank account as a primary source of security for extensions of credit and can do so only by obtaining a subordination agreement from the depositary bank or having the account entered in their own name. Consequently, the absence of publicity of the security right is not seen as problematic. The commentary will also explain that, unlike recommendation 120, subparagraph (b), recommendation 93 deals with priority conflicts between rights of set-off of the depositary bank and security rights of other persons. In addition, the commentary will explain that recommendation 93 does not create any rights of set-off, a matter that remains subject to other law. Moreover, the commentary will explain that the exception in recommendation 93 refers to a secured creditor that acquired control by becoming the sole account holder. Where the secured creditor would be just a joint account holder, the grantor will still be able to dispose of the funds credited to the account and thus the secured creditor would not have control (see definition (hh), "control").]

94. In the case of a transfer of funds from a bank account initiated by the grantor, the law should provide that the transferee of the funds takes free of a security right in the right to payment of funds credited to the bank account, unless the transferee has knowledge that the transfer violates the rights of the secured creditor under the security agreement. This recommendation does not lessen the rights of transferees of funds from bank accounts under law other than this law.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that the general priority recommendations apply to security rights in rights to payment of funds credited to a bank account subject to recommendations 120 and 121. The commentary will also explain that the test in recommendation 83, subparagraph (a) (see definition (uu), "buyer in the ordinary course of business"), and in recommendations 93 and 94 essentially the same (i.e. whether the buyer or transferee had knowledge that the sale or transfer violates the

rights of the secured creditor under the security agreement). The commentary will also explain that the term “transfer of funds” is intended to cover a variety of transfers, including by cheque and electronic means of communication (see A/61/17, para. 38).]

Priority of a security right in money

95. The law should provide that a person that obtains possession of money that is subject to a security right takes the money free of the security right, whether the money constitutes an original encumbered asset or proceeds, unless that person has knowledge that the transfer violates the rights of the secured creditor under the security agreement. This recommendation does not lessen the rights of holders of money under law other than this law.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that this recommendation is designed to promote the important policy of maximizing the negotiability of money, limiting negotiability only to the extent necessary to protect the holder of a security right in the money against collusion by a transferee of money and its transferor. It is intended that this recommendation be consistent with recommendation 94 dealing with security rights in funds transferred from a bank account.

The Working Group may also wish to note that the commentary will clarify that the term “money” in the Guide is intended to refer to, and only to, legal tender, that is, the currency currently in use as a medium of exchange authorized by a Government. Other forms of property are casually spoken of as money, but they are not money for purposes of the Guide. For example, if one deposits currency into one’s bank account, reference is often made to money in the bank (or cash in the bank), but the depositor’s asset is no longer money, it is instead, under the Guide, “funds credited to a bank account”. And the claim of the depositor against the bank is referred to in the Guide as the “right to payment of funds credited to a bank account”. Similarly, the deposit of a cheque would result in the depositor’s asset no longer being a negotiable instrument, but instead would be funds credited to a bank account. In addition, money held by a coin dealer as part of a collection is not “money” under the Guide.

The Guide addresses security rights in money both as original encumbered assets and as proceeds of another form of encumbered asset. An example of the latter case would be the receipt, by a seller that has granted a security right in its receivables, of payment of its outstanding invoices in currency (not by cheque or electronic funds transfer). Under the Guide, the money in the seller’s hands would be the proceeds of the seller’s receivable and the secured creditor would have a security right in the money as proceeds. Similarly, if a person that has granted a security right in an item of equipment sells it to a person who pays for it in cash, the money in the seller’s hands constitutes proceeds of the equipment and is subject to the security right.

Like money, funds credited to a bank account may be the subject of security rights either as original encumbered assets or as proceeds. If the currency and the cheques were subject to a security right in favour of the depositor’s creditor, the funds credited to the bank account would in both cases be the proceeds of the pre-existing encumbered asset (the money or the negotiable instrument). If the credit to the depositor’s bank account results from an electronic funds transfer from a third party in payment of a receivable owed by the transmitter to the depositor, the funds

credited to the bank account would be the proceeds of the pre-existing encumbered asset (the receivable).

Each provision of the Guide (e.g. rules for creation, effectiveness against third parties, priority and so on) applies to all encumbered assets, except to the extent a special rule is provided for a particular type of asset. Thus, it is always necessary to ascertain whether a special rule exists with respect to money or the right to payment of funds credited to a bank account.

An important example of a special rule is that which governs the rights of a transferee of: (a) money that, in the hands of a transferor, was subject to a security right; and (b) funds that were transferred from a bank account in which those funds, while owned by the transferor and credited to that bank account, were subject to a security right. Because of the need to preserve the negotiability of money and funds transferred from bank accounts, special rules are provided in the Guide to protect transferees of such assets.

With respect to money and funds credited to a bank account, it is important to focus on whether the issue under consideration concerns: (a) those two assets as property of the grantor; or (b) the rights of third-party transferees from the grantor of money or of funds transferred from the grantor's bank account. The preceding paragraph, which deals with the rule that governs the rights of transferees (the second category), illustrates this distinction. It is separate from the rule (the first category) that governs a priority contest between a security right in money or in funds credited to a bank account vis-à-vis a competing claimant when the grantor still owns (i.e. has not transferred) the encumbered asset.]

Priority of a security right in proceeds under an independent undertaking³³

96. The law should provide that a security right in proceeds under an independent undertaking, which has been made effective against third parties by control has, with respect to a particular guarantor/issuer, confirmer or nominated person giving value under an independent undertaking, priority over the rights of all other secured creditors that have, with respect to that person, made their security right effective against third parties by a method other than control. If control has been achieved by acknowledgement and inconsistent acknowledgements have been given to more than one secured creditor by a person, priority among those secured creditors is determined according to the order in which the acknowledgements were given.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that, as the typical method of achieving control is by obtaining an acknowledgment, in the case of several potential payors (e.g. the guarantor/issuer, confirmer and several nominated persons), control is achieved only vis-à-vis the particular guarantor/issuer(s), confirmer(s) or nominated person(s) who gave the acknowledgment(s). Thus, the priority rule must focus on the particular person that is the payor. The basic priority rule makes clear that a secured creditor that has control of the right to proceeds under an independent undertaking has priority over a secured creditor whose security right became effective against third parties automatically. The commentary will also explain that a guarantor/issuer, confirmer or nominated person may, without regard to priority, have a contractual right or obligation to pay an acknowledged secured creditor.]

³³ See A/CN.9/611/Add.1, recommendation 62.

Priority of a security right in a negotiable document³⁴

[Note to the Working Group: The Working Group may wish to note that the commentary will clarify that the general priority recommendations apply to security rights in negotiable documents, while recommendations 97 and 98 deal with additional priority conflicts.]

97. The law should provide that a security right in goods covered by a negotiable document, which is made effective against third parties by making the security right in the negotiable document effective against third parties, has priority over a security right in the goods, which is otherwise made effective against third parties while the goods are covered by the document.

98. The law should provide that a security right in a negotiable document and the goods covered thereby is subject to the rights under the law governing negotiable documents of a person to which the negotiable document has been duly negotiated.

Priority of a security right in attachments to immovable property³⁵

99. The law should provide that a security right or any other right (such as the right of a buyer or lessor) in attachments to immovable property, which is created and made effective against third parties under immovable property law, has priority over a security right in those attachments, which is made effective against third parties by one of the methods referred to in recommendation 33 or 35.

100. The law should provide that a security right in tangibles that are attachments to immovable property at the time the security right is made effective against third parties or that become attachments to immovable property subsequently, which is made effective against third parties by registration in the immovable property registry under recommendation 52, has priority over a security right or any other right (such as the right of a buyer or lessor) in the related immovable, which is registered subsequently.

[Note to the Working Group: The Working Group may wish to consider recommendations 99 and 100 together with the relevant recommendation in the chapter on acquisition financing devices (see recommendation 189). The commentary will explain that the words "any other right" refers to any right registrable under immovable property law.]

Priority of a security right in attachments to movable property subject to a specialized registration or title certificate system³⁶

101. The law should provide that a security right or other right (such as the right of a buyer or lessor) in attachments to movable property, which is made effective against third parties under law other than this law by registration in a specialized registry [or by notation on a title certificate], has priority over a security right in those attachments, which is made effective against third parties by one of the methods referred to in recommendations 33 or 35.

³⁴ For recommendations 97 and 98, see A/CN.9/611/Add.1, recommendations 80 and 81.

³⁵ For recommendations 99 and 100, see A/CN.9/WG.VI/WP.26/Add.4, recommendations 82 and 83.

³⁶ For recommendations 101 and 102, see A/CN.9/WG.VI/WP.26/Add.4, recommendations 84 and 84 bis.

[Note to the Working Group: The Working Group may wish to note that this recommendation is intended to determine priority between a security right in the attachment registered in the general security rights registry and a security right or other right in the same attachment registered in the specialized registry or noted on a title certificate. As recommendation 79 may be sufficient to address this contest, recommendation 101 may not be necessary.]

102. A security right or any other right (such as the right of a buyer or lessor) in attachments to movable property, which is made effective against third parties by registration in a specialized registry or by notation on a title certificate under recommendation 53, has priority over a security right or other right in the related movable property, which is registered subsequently.

[Note to the Working Group: The Working Group may wish to note that this recommendation is intended to determine priority between a security right or other right in an attachment registered in a specialized registry and a security right or other right in the related movable registered subsequently in the specialized registry. The Working Group may wish to consider whether there is any practical need for this recommendation in view of the absence of specialized registry systems that contemplate separate registration of security rights in an attachment. While aircraft registries do often provide for separate registration of engines they are not considered to become automatically part of the airframe but instead they are financed and registered separately.]

Priority of a security right in a mass or product³⁷

[Note to the Working Group: The Working Group may wish to note that priority between creditors with security rights in property that is commingled and becomes part of a mass or product and unsecured creditors require no special treatment since the regular priority rules apply once it is determined that the security right continues into the mass or product. There are, however, three types of potential priority contests between creditors each of which has a security right with respect to the resulting mass or product: (a) contests between security rights taken in the same tangibles that ultimately become part of a mass or product (e.g. sugar and sugar); (b) contests involving security rights in different tangibles that ultimately become part of a mass or product (e.g. sugar and flour); and (c) contests involving a security right originally taken in the separate tangibles and a security right in the mass or product (e.g. sugar and cake). In order to deal with all these situations, the relevant recommendation has been reformulated in three parts.]

103. The law should provide that a security right in the same separate tangibles, which continues in a mass or product and is effective against third parties, has the same priority, as against other security rights granted in the separate tangibles, it had immediately before the tangibles became part of the product or mass.

[Note to the Working Group: The Working Group may wish to note that the effect of the first sentence of this recommendation is to treat all security rights in tangibles that become commingled as having the same priority vis-à-vis each other as they had in the separate property. The rationale for this suggested rule is that the incorporation of goods into a mass or product should have no bearing on the respective rights of creditors with competing security rights in the separate goods.]

³⁷ For recommendations 103-105, see A/CN.9/WG.VI/WP.26/Add.4, recommendations 85, 85 bis and 85 ter.

The Working Group may wish to note that the rule is framed to respect both the general priority rules and to cover the super-priority afforded to creditors who may claim “acquisition security rights”. This recommendation is predicated on the assumption stated in recommendation 29 (creation) that a secured creditor may not receive an amount greater than the value of the tangible immediately before they became part of the mass or product.]

104. The law should provide that, if more than one security right in separate tangibles continues in the same mass or product and each security right is effective against third parties, the secured creditors are entitled to share in the aggregate value of their security rights in the mass or product according to the ratio of the value of the separate tangibles immediately before they became part of the mass or product. If there is more than one other security right, the holders of those other security rights are entitled to share in the remainder of the aggregate value of their security rights in the mass or product in the same ratio. If there is only one other security right, the holder of that other security right is entitled to the remainder of the value of its security right in the mass or product.

[Note to the Working Group: The Working Group may wish to note that, according to recommendation 104, if the value of the sugar is 2 and the flour 5, while the value of the cake is 6 and the amount of the secured obligation 7, the creditors will receive 2/7 and 5/7 of 6. In any case, if the value of the mass or product is less than the amount of the secured obligations, there will be no value left for unsecured creditors. The secured creditors have the same ranking and the object of the rule is to determine the relative value of their rights.]

105. The law should provide that a security right in separate tangibles, which continues in a mass or product and is effective against third parties, has priority over a security right granted by the same debtor in the mass or product, if it is an acquisition security right.

[Note to the Working Group: The Working Group may wish to note that the effect of the first sentence of this recommendation is to apply the general priority rules. Security rights in initial property have priority over all security rights in the mass or product that have been taken so as to cover future property, only if the former are acquisition security rights.]

VIII. Rights and obligations of the parties³⁸

Purpose

The purpose of the provisions of the law on rights and obligations of the parties is to enhance efficiency of secured transactions and reduce transaction costs and potential disputes by:

- (a) Providing rules on additional terms for the security agreement;
- (b) Eliminating the need to negotiate and draft terms to be included in the security agreement where the rules provide an acceptable basis for agreement;

³⁸ See A/CN.9/611/Add.2, purpose and recommendations 86-87.

- (c) Providing a drafting aid or checklist of issues the parties may wish to address at the time of negotiation and conclusion of the security agreement; and
- (d) Encouraging party autonomy.

A. General recommendations

Suppletive rules relating to the rights of the secured creditor

106. The law should provide that, unless otherwise agreed:

- (a) The secured creditor is entitled to be reimbursed for reasonable expenses incurred for the preservation of encumbered assets in its possession;
- (b) The secured creditor is entitled to make reasonable use of the encumbered assets in its possession and to inspect encumbered assets in the possession of the grantor.

Mandatory rules relating to the obligations of the party in possession

107. The law should provide that:

- (a) The secured creditor or the grantor in possession of the encumbered assets must take any steps necessary to preserve the encumbered assets;
- (b) The secured creditor must return the encumbered assets in its possession or terminate the notice registered upon full payment of the secured obligation and termination of all commitments to extend credit.

B. Asset-specific recommendations

Rights and obligations of the assignor and the assignee³⁹

[Note to the Working Group: The Working Group may wish to note that recommendations 108-111 are based on articles 11-14 of the United Nations Assignment Convention. The commentary will explain that they deal with the rights and obligations of the assignor and the assignee as between them.]

108. The law should provide that:

- (a) The mutual rights and obligations of the assignor and the assignee arising from their agreement are determined by the terms and conditions set forth in that agreement, including any rules or general conditions referred to therein;
- (b) The assignor and the assignee are bound by any usage to which they have agreed and, unless otherwise agreed, by any practices they have established between themselves.

³⁹ For recommendations 108-111, see A/CN.9/611, recommendations 16 bis-16 quinquies.

Representations of the assignor

109. [With respect to an assignment of a contractual receivable,] the law should provide that:

(a) Unless otherwise agreed between the assignor and the assignee, the assignor represents at the time of conclusion of the contract of assignment that:

- (i) The assignor has the right to assign the receivable;
- (ii) The assignor has not previously assigned the receivable to another assignee; and
- (iii) The debtor of the receivable does not and will not have any defences or rights of set-off;

(b) Unless otherwise agreed between the assignor and the assignee, the assignor does not represent that the debtor of the receivable has, or will have, the ability to pay.

[Note to the Working Group: The Working Group may wish to note that the bracketed language in the chapeau of this recommendation is intended to reflect the understanding of the Working Group that this recommendation should not apply to an assignment of a non-contractual receivable (see A/CN.9/603, para. 36; see also notes to definition (p), "receivable", and recommendations 2, subparagraph (a), and 22).]

Right to notify the debtor of the receivable

110. The law should provide that:

(a) Unless otherwise agreed between the assignor and the assignee, the assignor or the assignee or both may send the debtor of the receivable notification of the assignment and a payment instruction, but after notification has been sent only the assignee may send such an instruction; and

(b) Notification of the assignment or a payment instruction sent in breach of any agreement referred to in subparagraph (a) of this recommendation is not ineffective for the purposes of recommendation 114 by reason of such breach. However, nothing in this recommendation affects any obligation or liability of the party in breach of such an agreement for any damages arising as a result of the breach.

Right to payment

111. The law should provide that:

(a) As between the assignor and the assignee, unless otherwise agreed and whether or not notification of the assignment has been sent:

- (i) If payment in respect of the assigned receivable is made to the assignee, the assignee is entitled to retain the proceeds and goods returned in respect of the assigned receivable;
- (ii) If payment in respect of the assigned receivable is made to the assignor, the assignee is entitled to payment of the proceeds and also to goods returned to the assignor in respect of the assigned receivable; and

(iii) If payment in respect of the assigned receivable is made to another person over whom the assignee has priority, the assignee is entitled to payment of the proceeds and also to goods returned to such person in respect of the assigned receivable.

(b) The assignee may not retain more than the value of its right in the receivable.

IX. Rights and obligations of third-party obligors

A. Rights and obligations of the debtor of the receivable⁴⁰

Protection of the debtor of the receivable

[Note to the Working Group: The Working Group may wish to note that recommendations 112-118 are based on articles 15-21 of the United Nations Assignment Convention. The commentary will explain that these recommendations deal with the rights and obligations of the debtor of the receivable. The commentary will also explain that, if the debtor of the receivable makes payment in accordance with the recommendations in this part, the debtor of the receivable may obtain a valid discharge, irrespective of whether payment was made to the competing claimant with priority. Which one of several competing claimants will finally obtain the proceeds of the payment by the debtor of the receivable is a matter settled in the priority recommendations of the Guide (see, e.g. recommendation 152).]

112. The law should provide that:

(a) Except as otherwise provided in this law, an assignment does not, without the consent of the debtor of the receivable, affect the rights and obligations of the debtor of the receivable, including the payment terms contained in the original contract;

(b) A payment instruction may change the person, address or account to which the debtor of the receivable is required to make payment, but may not change:

(i) The currency of payment specified in the original contract; or

(ii) The State specified in the original contract in which payment is to be made to a State other than that in which the debtor of the receivable is located.

Notification of the debtor of the receivable

113. The law should provide that:

(a) Notification of the assignment or a payment instruction is effective when received by the debtor of the receivable if it is in a language that is reasonably expected to inform the debtor of the receivable about its contents. It is sufficient if notification of the assignment or a payment instruction is in the language of the original contract; and

(b) Notification of the assignment or a payment instruction may relate to receivables arising after notification; and

⁴⁰ For recommendations 112-118, see A/CN.9/611, recommendations 17-23.

(c) Notification of a subsequent assignment constitutes notification of all prior assignments.

Discharge of the debtor of the receivable by payment

114. The law should provide that:

(a) Until the debtor of the receivable receives notification of the assignment, it is entitled to be discharged by paying in accordance with the original contract;

(b) After the debtor of the receivable receives notification of the assignment, subject to subparagraphs (c)-(h) of this recommendation, it is discharged only by paying the assignee or, if otherwise instructed in the notification of the assignment or subsequently by the assignee in a writing received by the debtor of the receivable, in accordance with such payment instruction;

(c) If the debtor of the receivable receives more than one payment instruction relating to a single assignment of the same receivable by the same assignor, it is discharged by paying in accordance with the last payment instruction received from the assignee before payment;

(d) If the debtor of the receivable receives notification of more than one assignment of the same receivable made by the same assignor, it is discharged by paying in accordance with the first notification received;

(e) If the debtor of the receivable receives notification of one or more subsequent assignments, it is discharged by paying in accordance with the notification of the last of such subsequent assignments;

(f) If the debtor of the receivable receives notification of the assignment of a part of or an undivided interest in one or more receivables, it is discharged by paying in accordance with the notification or in accordance with this recommendation as if the debtor of the receivable had not received the notification. If the debtor of the receivable pays in accordance with the notification, it is discharged only to the extent of the part or undivided interest paid;

(g) If the debtor of the receivable receives notification of the assignment from the assignee, it is entitled to request the assignee to provide within a reasonable period of time adequate proof that the assignment from the initial assignor to the initial assignee and any intermediate assignment have been made and, unless the assignee does so, the debtor of the receivable is discharged by paying in accordance with this recommendation as if the notification from the assignee had not been received. Adequate proof of an assignment includes but is not limited to any writing emanating from the assignor and indicating that the assignment has taken place; and

(h) This recommendation does not affect any other ground on which payment by the debtor of the receivable to the person entitled to payment, to a competent judicial or other authority, or to a public deposit fund discharges the debtor of the receivable.

Defences and rights of set-off of the debtor of the receivable

115. The law should provide that:

(a) In a claim by the assignee against the debtor of the receivable for payment of the assigned receivable, the debtor of the receivable may raise against

the assignee all defences and rights of set-off arising from the original contract, or any other contract that was part of the same transaction, of which the debtor of the receivable could avail itself as if the assignment had not been made and such claim were made by the assignor;

(b) The debtor of the receivable may raise against the assignee any other right of set off, provided that it was available to the debtor of the receivable at the time notification of the assignment was received by the debtor of the receivable; and

(c) Notwithstanding subparagraphs (a) and (b) of this recommendation, defences and rights of set-off that the debtor of the receivable may raise pursuant to recommendation 23 or 24, against the assignor for breach of an agreement limiting in any way the assignor's right to make the assignment are not available to the debtor of the receivable against the assignee.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that, under recommendation 2, paragraph (b), the Guide applies to consumers but does not affect the rights of consumers under consumer-protection law.]

Agreement not to raise defences or rights of set-off

116. The law should provide that:

(a) The debtor of the receivable may agree with the assignor in a writing signed by the debtor of the receivable not to raise against the assignee the defences and rights of set-off that it could raise pursuant to recommendation 115. Such an agreement precludes the debtor of the receivable from raising against the assignee those defences and rights of set-off;

(b) The debtor of the receivable may not waive defences:

(i) Arising from fraudulent acts on the part of the assignee; or

(ii) Based on the incapacity of the debtor of the receivable; and

(c) Such an agreement may be modified only by an agreement in a writing signed by the debtor of the receivable. The effect of such a modification as against the assignee is determined by recommendation 117, subparagraph (b).

[Note to the Working Group: The Working Group may wish to note that this recommendation is based on article 19 of the United Nations Assignment Convention, which refers to a signed writing only for a waiver of defences or its modification. If the Working Group decides not to refer to signature in recommendation 13 but rather to evidence that the grantor intended to grant a security right, it may wish to reconsider the reference to signature in recommendation 116. If reference to signature is retained in recommendation 13, an electronic signature should be sufficient (see note to definition (v), "notification of the assignment", and recommendation 11.)]

Modification of the original contract

117. The law should provide that:

(a) An agreement concluded before notification of the assignment between the assignor and the debtor of the receivable that affects the assignee's rights is effective as against the assignee, and the assignee acquires corresponding rights;

(b) An agreement concluded after notification of the assignment between the assignor and the debtor of the receivable that affects the assignee's rights is ineffective as against the assignee unless:

- (i) The assignee consents to it; or
- (ii) The receivable is not fully earned by performance and either the modification is provided for in the original contract or, in the context of the original contract, a reasonable assignee would consent to the modification; and

(c) Subparagraphs (a) and (b) of this recommendation do not affect any right of the assignor or the assignee arising from breach of an agreement between them.

Recovery of payments

118. The law should provide that failure of the assignor to perform the original contract does not entitle the debtor of the receivable to recover from the assignee a sum paid by the debtor of the receivable to the assignor or the assignee.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that this recommendation does not affect any liability of the assignor towards the debtor of the receivable for breach of contract.]

B. Rights and obligations of the obligor under a negotiable instrument⁴¹

119. The law should provide that a secured creditor's rights in a negotiable instrument as against a person obligated on the negotiable instrument or any other person claiming rights under the law governing negotiable instruments are subject to the law governing negotiable instruments.

C. Rights and obligations of the depositary bank⁴²

120. The law should provide that:

(a) The creation of a security right in a right to payment of funds credited to a bank account does not affect the rights and obligations of the depositary bank without its consent; and

(b) The rights of set-off of the depositary bank are not impaired by reason of any security right that the depositary bank may have in a right to payment of funds credited to a bank account.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that recommendations 120 and 121 are supplemented by recommendations 92 and 93 (to the extent that there is a priority conflict between a security right or right of set-off of the depositary bank and a security right of another person), as well as recommendations 165-167 (enforcement of a security right in a right to payment of funds credited to a bank account).]

⁴¹ See A/CN.9/611/Add.1, recommendation X.

⁴² For recommendations 123-124, see A/CN.9/611/Add.1, recommendations V and W.

The commentary will also explain that recommendation 120, subparagraph (b), does not deal with a priority conflict but with the situation where the depositary bank itself has both a right of set-off against and a security right in a right to payment of funds credited to a bank account. In this situation, according to recommendation 120, subparagraph (b), the bank's rights of set-off are not impaired or subsumed into (i.e. they remain distinct from) the bank's security right.]

121. The law should provide that nothing in these recommendations obligates a depositary bank:

(a) To pay any person other than a person that has control with respect to funds credited to a bank account; or

(b) To respond to requests for information about whether a control agreement or a security right in its own favour exists and whether the grantor retains the right to dispose of the funds credited in the account.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that this recommendation does not affect the bank-customer relationship and the rights and obligations arising from other law governing bank accounts (e.g. money-laundering and bank secrecy).]

D. Rights and obligations of the guarantor/issuer, confirmer or nominated person of an independent undertaking⁴³

122. The law should provide that:

(a) A secured creditor's rights in proceeds under an independent undertaking are subject to the rights, under the law and practice governing independent undertakings, of the guarantor/issuer, confirmer or nominated person and of any other beneficiary named in the undertaking or to whom a transfer of drawing rights has been effected;

(b) The rights of a transferee-beneficiary of an independent undertaking are [not affected by] [superior to] a security right in a right to proceeds under the independent undertaking acquired from the transferor [or any prior transferor]; and

(c) The independent rights of a guarantor/issuer, confirmer, nominated person or transferee-beneficiary under an independent undertaking are not impaired by reason of any security right it may have in rights to proceeds under the independent undertaking, including any right in proceeds under the independent undertaking resulting from a transfer of drawing rights to a transferee-beneficiary.

[Note to the Working Group: The Working Group may wish to note that the commentary will make clear that this recommendation is intended to ensure that the rights of holders of independent rights to payment, notably nominated persons that have given value and transferee-beneficiaries to whom a transfer has been effected, are superior to the rights of mere assignees of rights in proceeds under a drawing by the original beneficiary. The commentary will also explain that their independent rights are distinct and are not impaired because of their rights as secured creditors of the original beneficiary (in other terms, their status as protected holders of independent rights should not be confused with their incidental status as secured

⁴³ For recommendations 120-122, see A/CN.9/611/Add.1, recommendations 25 bis, ter and quater.

creditors). When a nominated person gives value and obtains reimbursement from the issuer, it does so on the basis of its independent reimbursement rights and not as an acquirer of the rights of the beneficiary.]

123. The law should provide that a guarantor/issuer, confirmer or nominated person is not obligated to pay any person other than a confirmer, a nominated person, a named beneficiary, an acknowledged transferee-beneficiary of the independent undertaking or an acknowledged assignee of the proceeds under an independent undertaking.

124. The law should provide that, if a secured creditor obtains control by becoming an acknowledged assignee of the proceeds under an independent undertaking, the secured creditor has the right to enforce the acknowledgement against the guarantor/issuer, confirmer or nominated person that made the acknowledgement.

E. Rights and obligations of the issuer of a negotiable document⁴⁴

125. The law should provide that a secured creditor's rights in a negotiable document as against the issuer or any other person obligated on the negotiable document are subject to the law governing negotiable documents.

X. Default and enforcement⁴⁵

Purpose

The purpose of the provisions of the law on default and enforcement is to provide:

- (a) Clear and simple procedures for the enforcement of security rights after debtor default in a predictable and efficient manner;
- (b) Procedures that maximize the realization value of the encumbered assets for the benefit of the grantor, the debtor or any other person that owes payment of the secured obligation, the secured creditor and other creditors with a right in the encumbered assets;
- (c) Expeditious judicial and, subject to appropriate safeguards, non-judicial methods for the secured creditor to realize the value of the encumbered assets.

A. General recommendations

General standard of conduct in the context of enforcement

126. The law should provide that a person must exercise its rights and perform its obligations under the provisions of this law governing default and enforcement in good faith and in a commercially reasonable manner.

Limitations on party autonomy

127. The law should provide that rights and obligations under recommendation 126 cannot be waived unilaterally or varied by agreement at any time.

⁴⁴ See A/CN.9/611/Add.1, recommendation Z.

⁴⁵ See A/CN.9/611/Add.2, recommendations 89-124.

128. The law should provide that, subject to recommendation 127, the grantor and any other person that owes payment or other performance of the secured obligation may waive unilaterally or vary by agreement any of their rights and remedies under the provisions of this law governing default and enforcement, but only after default.

129. The law should provide that, subject to recommendation 127, the secured creditor may waive unilaterally or vary by agreement any of its rights and remedies under the provisions of this law governing default and enforcement at any time.

130. The law should provide that a variation of rights and remedies by agreement does not affect the rights of any person not a party to the agreement. A person challenging an agreement has the burden of showing that it was made prior to default or is inconsistent with recommendation 127.

Liability

131. The law should provide that a person is liable for damages arising from its failure to comply with its obligations under the provisions of this law governing default and enforcement.

[Note to the Working Group: The Working Group may wish to consider whether a waiver or variation of the liability arising under recommendation 131 should be addressed in recommendation 131 or left to other law.]

Rights and remedies after default

132. The law should provide that after default the grantor and the secured creditor have the rights and remedies set out in the provisions of this law governing default and enforcement, in the security agreement (except to the extent inconsistent with the provisions of this law) and in any other law.

Secured creditor rights and remedies

133. The law should provide that after default the secured creditor is entitled to exercise one or more of the following remedies with respect to an encumbered asset:

(a) Obtain possession of a tangible encumbered asset, as provided in recommendations 141 and 142;

(b) Sell or otherwise dispose of, lease or license an encumbered asset, as provided in recommendation 143;

(c) Propose to the grantor that the secured creditor accept an encumbered asset in total or partial satisfaction of the secured obligation, as provided in recommendations 147-150;

(d) Collect on or otherwise enforce a security right in an encumbered asset that is a receivable, negotiable instrument, right to payment of funds credited to a bank account or proceeds under an independent undertaking, as provided in recommendations 160-168;

(e) Enforce rights under a negotiable document, as provided in recommendation 169;

(f) Enforce its security right in an attachment to immovable property, as provided in recommendation 170; and

(g) Exercise any other right or remedy provided in the security agreement (except to the extent inconsistent with the provisions of this law) or any other law.

Judicial and extrajudicial enforcement

134. The law should provide that after default the secured creditor may exercise its rights and remedies provided in recommendation 133 by applying to a court or other authority. Subject to the general standard of conduct provided in recommendation 126 and the requirements provided in recommendations 141-146 with respect to extrajudicial possession and disposition, the secured creditor may elect to exercise its rights and remedies provided in recommendation 133 without having to apply to a court or other authority.

Grantor rights and remedies

135. The law should provide that after default the grantor is entitled to exercise one or more of the following remedies:

(a) Pay in full the secured obligation and obtain a release from the security right of all encumbered assets, as provided in recommendation 139;

(b) Apply to a court or other authority for relief if the secured creditor is not complying with its obligations under the provisions of this law governing default and enforcement relating to extrajudicial enforcement, as provided in recommendation 140;

(c) Propose to the secured creditor, or reject the proposal of the secured creditor, that the secured creditor accept an encumbered asset in total or partial satisfaction of the secured obligation, as provided in recommendations 147-150; and

(d) Exercise any other right or remedy provided in the security agreement (except to the extent inconsistent with the provisions of this law governing default and enforcement) or any other law.

Summary judicial proceedings

136. The law should provide for summary judicial proceedings with respect to the exercise of rights and remedies of the secured creditor, the grantor and any other person that owes performance of the secured obligation or claims to have a right in an encumbered asset.

Cumulative rights and remedies

137. The law should provide that the exercise of a right or remedy does not prevent the exercise of another right or remedy, unless the exercise of a right or remedy has made the exercise of another right or remedy impossible.

[Note to the Working Group: The Working Group may wish to note that the commentary will clarify that the exercise of one remedy (e.g. repossession and disposition of an encumbered asset) may make the exercise of another remedy (e.g. acceptance of an encumbered asset in satisfaction of the secured obligation) impossible.]

Rights and remedies with respect to the secured obligation

138. The law should provide that the exercise of a right or remedy with respect to an encumbered asset does not prevent the exercise of a right or remedy with respect to the obligation secured by that asset, and vice versa.

Release of the encumbered assets after full payment

139. The law should provide that, after default and until the disposition, acceptance or collection of an encumbered asset by the secured creditor, the debtor, the grantor or any other interested person (e.g. a secured creditor whose security right has lower priority than that of the enforcing secured creditor, a guarantor or a co-owner of the encumbered assets) is entitled to pay the secured obligation in full, including interest and the costs of enforcement up to the time of full payment. If all commitments to extend credit have terminated, full payment extinguishes the security right in all encumbered assets and, to the extent provided in law other than this law, subrogates the person making the payment to the rights of the secured creditor.

Court relief

140. The law should provide that the debtor, the grantor or any other interested person (e.g. a secured creditor with a lower priority ranking than that of the enforcing secured creditor, a guarantor or a co-owner of the encumbered assets) is entitled at any time to apply to a court or other authority for relief from the secured creditor's failure to comply with its obligations under the provisions of this law governing default and enforcement. Unfounded applications and improper interference with or undue delay of the enforcement process should be discouraged and avoided.

[Note to the Working Group: The Working Group may wish to consider whether the principle with respect to the right to apply to court for relief by the debtor, grantor or other interested third persons should generally apply to the exercise of all rights and remedies under the recommendations of this chapter and not only with respect to extrajudicial enforcement. The Working Group may wish to consider specifying the safeguards necessary to discourage unfounded applications and improper interference with the enforcement process.]

Secured creditor's right to take possession of an encumbered asset

141. The law should provide that after default the secured creditor is entitled to possession of a tangible encumbered asset.

Alternative A

142. The law should provide that the secured creditor may elect to take possession of the encumbered asset without applying to a court or other authority only if:

- (a) The grantor has consented in the security agreement to the secured creditor obtaining possession without applying to a court or other authority;
- (b) The secured creditor has given the grantor and any person in possession of the encumbered asset notice of default; and
- (c) Possession can be taken without the use or threat of force.

Alternative B

142. The law should provide that the secured creditor may elect to take possession of the encumbered asset without applying to a court or other authority only if:

(a) The grantor has consented in the security agreement to the secured creditor obtaining possession without applying to a court or other authority;

(b) The secured creditor has given the grantor and any person in possession of the encumbered asset notice of default and of its intention to pursue extrajudicial enforcement with details as to the time and modalities of enforcement; and

(c) [Possession can be taken without the use or threat of force, or any other illegal act.] [At the time of extrajudicial enforcement the grantor does not object.]

[Note to the Working Group: The Working Group may wish to note that, while under either alternative the grantor has to consent in the security agreement, the alternatives differ as to the requirements for notices and the safeguards for the grantor.]

Disposition of encumbered assets

143. The law should provide that after default a secured creditor is entitled to sell or otherwise dispose of, lease or license an encumbered asset. Subject to recommendation 126, a secured creditor that elects to exercise this remedy without applying to a court or other authority may select the method, manner, time, place, and other aspects of the disposition, lease or license.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that the purpose and effect of this recommendation is to provide a balance between the interests of both the grantor (and its other creditors) and the secured creditor in enabling flexibility in the methods used to dispose of the encumbered assets in order to obtain an economically effective enforcement, while at the same time protecting the grantor against actions taken by the secured creditor that, in the commercial context, are not reasonable. The commentary will also explain that the secured creditor need not be in possession of the encumbered assets to exercise its rights and remedies under this chapter.]

Advance notice of extrajudicial disposition

144. The law should provide that after default the secured creditor must give notice of its intention to pursue extrajudicial disposition, lease or licence of an encumbered asset.

145. The law should:

(a) Provide that the notice must be given:

(i) To the grantor, the debtor and any other person that owes payment of the secured obligation;

(ii) To any person with rights in the encumbered asset that, prior to the sending of the notice by the secured creditor to the grantor, notifies in writing the secured creditor of those rights, and

(iii) To any other secured creditor that, more than [...] days before the notice is sent to the grantor, registers a notice of a security right in the encumbered

asset under the name of the grantor or that is in possession of the encumbered asset at the time it is seized by the secured creditor;

(b) State the manner in which the notice must be given, its timing and its minimum contents, including whether the notice [to the grantor] must contain an accounting of the amount then owed and a reference to the right of the debtor or the grantor to obtain the release of the encumbered assets from the security right as provided in recommendation 139;

(c) Provide that the notice must be in a language that is reasonably expected to inform its recipients about its contents;

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that the notice to the grantor is sufficient if it is in the language of the security agreement and, if the security right was made effective against third parties by registration, notice under this recommendation is sufficient if it is in the language of the registry.]

(d) Address the legal consequences of failure to comply with the recommendations governing the notice; and

[Note to the Working Group: The Working Group may wish to consider whether subparagraph (d) is necessary. Recommendation 131 deals with the liability of the secured creditor for failure to comply with its obligations under this law. In addition, recommendation 140 entitles the grantor to obtain judicial relief if a secured creditor pursuing extrajudicial enforcement violates its obligations under this law. Moreover, the note to recommendation 158 suggests the inclusion of a new recommendation dealing with the consequences of a failure of the secured creditor to comply with its obligations with regard to the rights acquired by a good faith buyer, lessee or licensee.]

(e) List circumstances in which the notice need not be given either because the delay associated with requiring advance notice could have a negative effect on the realization value of the encumbered assets (as in the case of perishable tangibles or other assets whose value may decline speedily) or because the encumbered assets are of a type sold on a recognized market and therefore have their value set by that market.

146. The law should provide rules ensuring that the notice referred to in recommendation 144 can be given in an efficient, timely and reliable way so as to protect the grantor or other interested parties, while, at the same time, avoiding having a negative effect on the secured creditor's remedies and the potential realization value of the encumbered assets.

[Note to the Working Group: The Working Group may wish to consider whether this recommendation 146 should be more specific or included in the commentary. The Working Group may also wish to note that the commentary will explain that these rules should balance the interest of the secured creditor in having the flexibility to dispose of the encumbered asset promptly in order to take advantage of favourable market conditions (an interest that also benefits the grantor and other interested parties) with the interest of the grantor and those other parties in obtaining notice of an extrajudicial disposition sufficiently before the disposition in order to take actions that might further protect their interests (such as locating potential buyers for the encumbered asset or attending a public disposition of the encumbered asset to verify the secured creditor's compliance with its

obligations under the provisions of the law governing default and enforcement). The commentary will also explain that the recommendation does not require registration of the notice because the notice meets the policy goals that could be served by registration.]

Acceptance of encumbered assets in satisfaction of the secured obligation

147. The law should provide that after default the secured creditor may propose in writing that the secured creditor accept one or more of the encumbered assets in total or partial satisfaction of the secured obligation.

148. The law should provide that a secured creditor that proposes that the secured creditor accept an encumbered asset in total or partial satisfaction of the secured obligation must send notice of the proposal, specifying the amount owed as of the date the proposal is sent and the amount of the obligation that is proposed to be satisfied by accepting the encumbered asset:

(a) To the grantor, the debtor and any other person that owes payment of the secured obligation (e.g. a guarantor);

(b) To any person with rights in the encumbered asset that, more than [...] days prior to the sending of the proposal by the secured creditor to the grantor, has notified in writing the secured creditor of those rights; and

(c) To any other secured creditor that, more than [...] days before the proposal is sent to the grantor, has registered a notice of a security right in the encumbered asset in the name of the grantor [more than [...] days before the proposal is sent to the grantor] or that was in possession of the encumbered asset at the time it was seized by the secured creditor.

149. The law should provide that, if any addressee of a proposal under recommendation 148 objects in writing within a short time, such as 20 days, after the proposal is sent, the secured creditor may not proceed with the proposal.

150. The law should provide that, if the grantor makes the proposal referred to in recommendation 147 and the secured creditor accepts it, the secured creditor must proceed as provided in recommendations 148 and 149.

Distribution of proceeds of enforcement

151. The law should provide that, in the case of extrajudicial disposition of an encumbered asset or collection of a receivable, negotiable instrument or other obligation, the enforcing secured creditor must apply the net proceeds of its enforcement (after deducting costs of enforcement) to the secured obligation. Except as provided in recommendation 152, the enforcing secured creditor must pay any surplus remaining to any subordinate competing claimant, that, prior to any distribution of the surplus, gave notice of its claim to the enforcing secured creditor, to the extent of that claim. Any balance remaining must be remitted to the grantor.

152. The law should also provide that, in the case of extrajudicial enforcement, whether or not there is any dispute as to the entitlement of any competing claimant or as to the priority of payment, the enforcing secured creditor may, in accordance with generally applicable procedural rules, pay the surplus to a competent judicial or other authority or to a public deposit fund for distribution. The surplus should be distributed in accordance with the priority rules of this law.

153. The law should provide that distribution of the proceeds realized by a judicial disposition or other officially administered enforcement process is to be made pursuant to the general rules of the State governing execution proceedings, but in accordance with the priority rules of this law.

154. The law should provide that, unless otherwise agreed, the debtor and any other person that owes payment of the secured obligation are liable for any shortfall still owing after application of the net proceeds of enforcement to the secured obligation.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that this recommendation provides that the secured creditor has an unsecured claim for any shortfall remaining after payment of the secured obligation. The commentary will also explain that the secured creditor and the grantor may agree in the context of non-recourse or limited-recourse transactions that the secured creditor has no claim for any shortfall.]

Right of prior-ranking secured creditor to take over enforcement

155. The law should provide that, where a secured creditor or a judgement creditor has commenced enforcement, a secured creditor whose security right has priority over that of the enforcing secured creditor or the enforcing judgement creditor is entitled to take control of the enforcement process at any time before final disposition, acceptance or collection of an encumbered asset. The right to take control includes the right to enforce by any method available under this law.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that the secured creditor with priority has the right to substitute its own enforcement process under this law for judgement enforcement proceedings initiated by a subordinate judgement creditor under other law but does not have the right to continue the enforcement process initiated by the judgement creditor under that other law.]

Rights acquired through judicial disposition

156. The law should provide that, if a secured creditor disposes of an encumbered asset through a judicial or other officially administered process, the rights acquired by the transferee are determined by the general rules of the State governing execution proceedings.

Rights acquired through extrajudicial disposition

157. The law should provide that, if a secured creditor disposes of an encumbered asset without applying to a court or other authority, a good faith purchaser acquires the grantor's right in the asset subject to rights that have priority over the security right of the enforcing secured creditor, but free of rights of the enforcing secured creditor and any competing claimant whose right has a lower priority than that of the enforcing secured creditor. The same rule applies to rights in an encumbered asset acquired by a secured creditor that has accepted the asset in total or partial satisfaction of the secured obligation.

158. The law should provide that, if a secured creditor leases or licenses an encumbered asset without applying to a court or other authority, a good faith lessee or licensee is entitled to the benefit of the lease or licence during the term thereof, except as against rights that have priority over the security right of the enforcing secured creditor.

[Note to the Working Group: The Working Group may wish to consider whether a new recommendation should be included in this chapter along the following lines: “The law should provide that failure of the secured creditor to comply with any of its obligations under the provisions of the law on default and enforcement does not affect the rights of a good faith buyer, lessee or licensee of the encumbered asset.”]

Intersection of movable and immovable property enforcement regimes

159. The law should provide that:

(a) The secured creditor may elect to enforce a security right in attachments to immovable property in accordance with this law or the law governing enforcement of encumbrances in immovable property; and

(b) If an obligation is secured by both movable and immovable property of a grantor, the secured creditor may elect to enforce:

(i) The security right in the movable property under this law and the encumbrance in the immovable property under the law governing enforcement of encumbrances in immovable property; or

(ii) Both rights under the law governing enforcement of encumbrances in immovable property.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that the law should be coordinated with general civil procedure law to provide a right for secured creditors to intervene in court proceedings initiated by other creditors of the grantor so as to protect security rights and to ensure the same priority status of security rights as under the law.]

B. Asset-specific recommendations

Application of the chapter on enforcement to outright transfers of receivables⁴⁶

160. The law should provide that the provisions of the law on default and enforcement do not apply to an outright transfer of receivables with the exception of:

(a) Recommendation 126 in the case of an outright transfer with recourse; and

(b) Recommendations 161 and 162.

Enforcement of a security right in a receivable⁴⁷

161. The law should provide that, in the case of an outright transfer of a receivable, the assignee has the right to collect or otherwise enforce the receivable. In the case of a transfer of a receivable by way of security, the assignee is entitled, subject to recommendations 112 to 118, to collect or otherwise enforce the receivable after default, or before default with the agreement of the assignor.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that the secured creditor may, as an alternative to

⁴⁶ See A/CN.9/611, recommendation 88.

⁴⁷ For recommendations 161 and 162, see A/CN.9/611, recommendations 102 and 103.

collection, elect to sell a receivable pursuant to recommendations 133, subparagraph (d), and 143. The commentary will also explain that a notification and a payment instruction sent in breach of an agreement between the assignee and the assignor not to notify the debtor of the receivable obligates the debtor of the receivable to pay the assignee but the assignee may be liable to the assignor for breach of contract (see recommendation 110, subparagraph (b)).]

162. The law should provide that the assignee's right to collect or otherwise enforce a receivable includes the right to collect or otherwise enforce any personal or property right that secures payment of the receivable (such as a guarantee or security right).

[Note to the Working Group: The Working Group may wish to note that the commentary will discuss how other recommendations of the chapter on enforcement may apply to the enforcement of a right securing payment of an assigned receivable.]

Enforcement of a security right in a negotiable instrument⁴⁸

163. The law should provide that after default, or before default with the agreement of the grantor, the secured creditor is entitled, subject to recommendation 119, to collect or otherwise enforce a negotiable instrument that is an encumbered asset against a person obligated on that instrument.

[Note to the Working Group: The Working Group may wish to note that commentary will explain that as between the secured creditor and the person obligated on the negotiable instrument or other persons claiming rights under the law governing negotiable instruments, the enforcement rights of the secured creditor are subject to the law governing negotiable instruments. The commentary will also include the following examples of such persons:

(a) The person obligated on the negotiable instrument may be obligated to pay only a holder or other person entitled to enforce the instrument under the law governing negotiable instruments; and

(b) The right of the person obligated on the instrument to raise defences to that obligation is determined by the law governing negotiable instruments.]

164. The law should provide that the secured creditor's right to collect or otherwise enforce a negotiable instrument includes the right to collect or otherwise enforce any personal or property right that secures payment of the negotiable instrument (such as a guarantee or security right).

Enforcement of a security right in a right to payment of funds credited to a bank account⁴⁹

165. The law should provide that after default, or before default with the agreement of the grantor, a secured creditor with a security right in a right to payment of funds credited to a bank account is entitled, subject to recommendations 119 and 120, to collect or otherwise enforce its right to payment of the funds.

⁴⁸ For recommendations 163 and 164, see A/CN.9/611/Add.1, recommendations 104 and 105.

⁴⁹ For recommendations 165-167, see A/CN.9/611/Add.1, recommendations 106 bis, 107 and 108.

166. The law should provide that after default, or before default with the agreement of the grantor, a secured creditor that has control is entitled, subject to recommendations 120 and 121, to enforce its security right without having to apply to a court or other authority.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that, unlike a secured creditor that has to collect the funds to apply them to the secured obligation according to recommendation 151, a depositary bank as a secured creditor may apply the funds to the secured obligation directly. The commentary will also explain that enforcement of the bank's rights of set-off remains subject to other law.]

167. The law should provide that a secured creditor that does not have control is entitled, subject to recommendations 120 and 121, to collect or otherwise enforce the security right against the depositary bank only pursuant to a court order, unless the depositary bank agrees otherwise.

Enforcement of a security right in proceeds under an independent undertaking⁵⁰

168. The law should provide that after default, or before default with the agreement of the grantor, a secured creditor with a security right in proceeds under an independent undertaking is entitled, subject to recommendations 122 to 124, to collect or otherwise enforce its right in the proceeds under the independent undertaking.

[Note to the Working Group: The Working Group may wish to note that the commentary will make clear that no separate act of transfer by the grantor is necessary for the secured creditor to enforce a security right in a right to proceeds under an independent undertaking when the security right is created automatically under recommendation 24. The commentary will also explain that any obligations of the guarantor/issuer or nominated person to the secured creditor are governed by recommendations 122 to 124. Furthermore, the commentary will explain that recommendation 168 is not intended to disturb any pre-default arrangements agreed upon between the grantor and the secured creditor by which, prior to the grantor's default, the secured creditor may receive the proceeds under an independent undertaking.]

Enforcement of a security right in a negotiable document⁵¹

[Note to the Working Group: The Working Group may wish to note that the commentary will also explain that the general recommendations on enforcement of security rights apply here as well. Recommendation 169 deals with a special issue.]

169. The law should provide that after default, or before default with the agreement of the grantor, the secured creditor is entitled, subject to recommendation 125, to enforce a security right in a negotiable document against the issuer or any other person obligated on the negotiable document.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that, under law governing negotiable documents, the issuer may be obligated to deliver the goods only to a holder of the negotiable document covering the goods.]

⁵⁰ See A/CN.9/611/Add.1, recommendation 106.

⁵¹ See A/CN.9/611/Add.1, recommendation 109.

Enforcement of a security right in attachments to immovable property⁵²

[Note to the Working Group: The Working Group may wish to consider that the general recommendations apply to the enforcement of a security right in attachments to movable property. As to the enforcement of security rights in attachments to immovable property, the Working Group may wish to consider an additional recommendation along the lines of recommendation 170.]

170. The law should provide that a secured creditor with a security right in an attachment to immovable property is entitled to enforce its security right only if it has priority over competing rights in the immovable property. In the case of such an enforcement, a creditor with a competing right in immovable property that has lower priority ranking is entitled to pay off the obligation secured by a security right in the attachment. The enforcing secured creditor is liable for any damage to the immovable property caused by the act of removal other than any diminution in its value attributable solely to the absence of the attachment.

XI. Insolvency⁵³**A. UNCITRAL Legislative Guide on Insolvency Law: definitions and recommendations****Definitions⁵⁴**

12. (b) “Assets of the debtor”:⁵⁵ property, rights and interests of the debtor, including rights and interests in property, whether or not in the possession of the debtor, tangible or intangible, movable or immovable, including the debtor’s interests in encumbered assets or in third party-owned assets;

12. (dd) “Party in interest”: any party whose rights, obligations or interests are affected by insolvency proceedings or particular matters in the insolvency proceedings, including the debtor, the insolvency representative, a creditor, an equity holder, a creditor committee, a government authority or any other person so affected. It is not intended that persons with remote or diffuse interests affected by the insolvency proceedings would be considered to be a party in interest;

⁵² See A/CN.9/WG.VI/WP.26/Add.4, note on the enforcement of a security right in attachments.

⁵³ See A/CN.9/WG.VI/WP.21/Add.3.

⁵⁴ These definitions are taken from the glossary of the *UNCITRAL Legislative Guide on Insolvency Law* (“the *Insolvency Guide*”) (Introduction, para. 12).

⁵⁵ For the purposes of this chapter, the term “debtor” as used in the recommendations taken from the *Insolvency Guide* should be read as referring to a person who meets the requirements for the commencement of insolvency proceedings (see *Insolvency Guide*, part two, chapter I, section A, paras. 1-11, and recommendation 8). Where the security right at issue (which secures the debtor’s obligation) is granted by the debtor, the term “debtor” also refers to the grantor. However, where the security right at issue is granted not by the debtor but by a third party (e.g. on the basis of some contractual arrangement with the debtor), the term “debtor” refers to the third-party grantor, since only in that third-party grantor’s insolvency is the secured creditor a secured creditor with a proprietary right in the encumbered assets. In the insolvency of a non-grantor debtor, the creditor is an unsecured creditor with an unsecured claim against the non-grantor debtor.

12. (pp) “Security interest”: a right in an asset to secure payment or other performance of one or more obligations.

[*Note to the Working Group: The Working Group may wish to note that the insolvency chapter may need to address other terms used in the Insolvency Guide and the Secured Transactions Guide.*]

Recommendations⁵⁶

Key objectives of an efficient and effective insolvency law

(1) In order to establish and develop an effective insolvency law, the following key objectives should be considered:

- (a) Provide certainty in the market to promote economic stability and growth;
- (b) Maximize value of assets;
- (c) Strike a balance between liquidation and reorganization;
- (d) Ensure equitable treatment of similarly situated creditors;
- (e) Provide for timely, efficient and impartial resolution of insolvency;
- (f) Preserve the insolvency estate to allow equitable distribution to creditors;
- (g) Ensure a transparent and predictable insolvency law that contains incentives for gathering and dispensing information; and
- (h) Recognize existing creditors rights and establish clear rules for ranking of priority claims.

(4) The insolvency law should specify that where a security interest is effective and enforceable under law other than the insolvency law, it will be recognized in insolvency proceedings as effective and enforceable.

(7) In order to design an effective and efficient insolvency law, the following common features should be considered:

- (a)-(d) ...
- (e) Protection of the insolvency estate against the actions of creditors, the debtor itself and the insolvency representative, and where the protective measures apply to secured creditors, the manner in which the economic value of the security interest will be protected during the insolvency proceedings;
- (f)-(r) ...

Law applicable to validity and effectiveness of rights and claims

(30) The law applicable to the validity and effectiveness of rights and claims existing at the time of the commencement of insolvency proceedings should be

⁵⁶ It should be noted that this chapter includes only the recommendations or parts of recommendations of the *Insolvency Guide* that relate specifically to security rights, with the original numbers from the *Insolvency Guide* (for the recommendations not reproduced in this chapter, see the *Insolvency Guide* available at <http://www.uncitral.org>). It should also be noted that the final text of the recommendations will include the necessary footnotes from the *Insolvency Guide*.

determined by the private international law rules of the State in which insolvency proceedings are commenced.

Law applicable in insolvency proceedings: lex fori concursus

(31) The insolvency law of the State in which insolvency proceedings are commenced (lex fori concursus) should apply to all aspects of the commencement, conduct, administration and conclusion of those insolvency proceedings and their effects. These may include, for example:

- (a)-(i) ...
- (j) Treatment of secured creditors;
- (k)-(n) ...
- (o) Ranking of claims;
- (p)-(s) ...

Assets constituting the estate

(35) The insolvency law should specify that the estate should include:

- (a) Assets of the debtor, including the debtor's interest in encumbered assets and in third party-owned assets;
- (b) Assets acquired after commencement of the insolvency proceedings; and
- (c) ...

Provisional measures

(39) The insolvency law should specify that the court may grant relief of a provisional nature, at the request of the debtor, creditors or third parties, where relief is needed to protect and preserve the value of the assets of the debtor or the interests of creditors, between the time an application to commence insolvency proceedings is made and commencement of the proceedings, including:

- (a) Staying execution against the assets of the debtor, including actions to make security interests effective against third parties and enforcement of security interests;
- (b)-(d) ...

Measures applicable on commencement

(46) The insolvency law should specify that, on commencement of insolvency proceedings:

- (a) Commencement or continuation of individual actions or proceedings concerning the assets of the debtor, and the rights, obligations or liabilities of the debtor are stayed;
- (b) Actions to make security interests effective against third parties and to enforce security interests are stayed;
- (c) Execution or other enforcement against the assets of the estate is stayed;

(d) The right of a counterparty to terminate any contract with the debtor is suspended; and

(e) The right to transfer, encumber or otherwise dispose of any assets of the estate is suspended.

Duration of measures automatically applicable on commencement

(49) The insolvency law should specify that the measures applicable on commencement of insolvency proceedings remain effective throughout those proceedings until:

(a) The court grants relief from the measures;

(b) In reorganization proceedings, a reorganization plan becomes effective; or

(c) In the case of secured creditors in liquidation proceedings, a fixed time period specified in the law expires, unless it is extended by the court for a further period on a showing that:

(i) An extension is necessary to maximize the value of assets for the benefit of creditors; and

(ii) The secured creditor will be protected against diminution of the value of the encumbered asset in which it has a security interest.

Protection from diminution of the value of encumbered assets

(50) The insolvency law should specify that, upon application to the court, a secured creditor should be entitled to protection of the value of the assets in which it has a security interest. The court may grant appropriate measures of protection that may include:

(a) Cash payments by the estate;

(b) Provision of additional security interests; or

(c) Such other means as the court determines.

Relief from measures applicable on commencement

(51) The insolvency law should specify that a secured creditor may request the court to grant relief from the measures applicable on commencement of insolvency proceedings on grounds that may include that:

(a) The encumbered asset is not necessary to a prospective reorganization or sale of the debtor's business;

(b) The value of the encumbered asset is diminishing as a result of the commencement of insolvency proceedings and the secured creditor is not protected against that diminution of value; and

(c) In reorganization, a plan is not approved within any applicable time limits.

Power to use and dispose of assets of the estate

(52) The insolvency law should permit:

(a) The use and disposal of assets of the estate (including encumbered assets) in the ordinary course of business, except cash proceeds; and

(b) The use and disposal of assets of the estate (including encumbered assets) outside the ordinary course of business, subject to the requirements of recommendations 55 and 58.

Further encumbrance of encumbered assets

(53) The insolvency law should specify that encumbered assets may be further encumbered, subject to the requirements of recommendations 65-67.

Use of third-party-owned assets

(54) The insolvency law should specify that the insolvency representative may use an asset owned by a third party and in the possession of the debtor provided specified conditions are satisfied, including:

(a) The interests of the third party will be protected against diminution in the value of the asset; and

(b) The costs under the contract of continued performance of the contract and use of the asset will be paid as an administrative expense.

Ability to sell assets of the estate free and clear of encumbrances and other interests

(58) The insolvency law should permit the insolvency representative to sell assets that are encumbered or subject to other interest free and clear of that encumbrance and other interest, outside the ordinary course of business, provided that:

(a) The insolvency representative gives notice of the proposed sale to the holders of encumbrances or other interests;

(b) The holder is given the opportunity to be heard by the court where they object to the proposed sale;

(c) Relief from the stay has not been granted; and

(d) The priority of interests in the proceeds of sale of the asset is preserved.

Use of cash proceeds

(59) The insolvency law should permit the insolvency representative to use and dispose of cash proceeds if:

(a) The secured creditor with a security interest in those cash proceeds consents to such use or disposal; or

(b) The secured creditor was given notice of the proposed use or disposal and an opportunity to be heard by the court; and

(c) The interests of the secured creditor will be protected against diminution in the value of the cash proceeds.

Burdensome assets

(62) The insolvency law should permit the insolvency representative to determine the treatment of any asset that is burdensome to the estate. In particular, the insolvency law may permit the insolvency representative to relinquish a burdensome asset following the provision of notice to creditors and the opportunity for creditors to object to the proposed action, except that where a secured claim exceeds the value of the encumbered asset, and the asset is not required for a reorganization or sale of the business as a going concern, the insolvency law may permit the insolvency representative to relinquish the asset to the secured creditor without notice to other creditors.

Security for post-commencement finance

(65) The insolvency law should enable a security interest to be granted for repayment of post-commencement finance, including a security interest on an unencumbered asset, including an after-acquired asset, or a junior or lower priority security interest on an already encumbered asset of the estate.

(66) The law should specify that a security interest over the assets of the estate to secure post-commencement finance does not have priority ahead of any existing security interest over the same assets unless the insolvency representative obtains the agreement of the existing secured creditor(s) or follows the procedure in recommendation 67.

(67) The insolvency law should specify that, where the existing secured creditor does not agree, the court may authorize the creation of a security interest having priority over pre-existing security interests provided specified conditions are satisfied, including:

- (a) The existing secured creditor was given the opportunity to be heard by the court;
- (b) The debtor can prove that it cannot obtain the finance in any other way; and
- (c) The interests of the existing secured creditor will be protected.

Effect of conversion on post-commencement finance

(68) The insolvency law should specify that where reorganization proceedings are converted to liquidation, any priority accorded to post-commencement finance in the reorganization should continue to be recognized in the liquidation.

Automatic termination and acceleration clauses

(70) The insolvency law should specify that any contract clause that automatically terminates or accelerates a contract upon the occurrence of any of the following events is unenforceable as against the insolvency representative and the debtor:

- (a) An application for commencement, or commencement, of insolvency proceedings;
- (b) The appointment of an insolvency representative.

(71) The insolvency law should specify the contracts that are exempt from the operation of recommendation 70, such as financial contracts, or subject to special rules, such as labour contracts.

(72) The insolvency law should specify that the insolvency representative may decide to continue the performance of a contract of which it is aware where continuation would be beneficial to the insolvency estate. The insolvency law should specify that:

(a) The right to continue applies to the contract as a whole; and

(b) The effect of continuation is that all terms of the contract are enforceable.

Performance prior to continuation or rejection

(80) The insolvency law should specify that the insolvency representative may accept or require performance from the counterparty to a contract prior to continuation or rejection of the contract. Claims of the counterparty arising from performance accepted or required by the insolvency representative prior to continuation or rejection of the contract should be payable as an administrative expense:

(a) If the counterparty has performed the contract the amount of the administrative expense should be the contractual price of the performance; or

(b) If the insolvency representative uses assets owned by a third party that are in the possession of the debtor subject to contract, that party should be protected against diminution of the value of those assets and have an administrative claim in accordance with subparagraph (a).

[Note to the Working Group: The Working Group may wish to note that the commentary will make it clear that rejection of a credit agreement does not terminate the security agreement and does not extinguish the security right.]

Avoidance of security interests

(88) The insolvency law should specify that notwithstanding that a security interest is effective and enforceable under law other than the insolvency law, it may be subject to the avoidance provisions of insolvency law on the same grounds as other transactions.

Financial contracts

(103) Once the financial contracts of the debtor have been terminated, the insolvency law should permit counterparties to enforce and apply their security interest to obligations arising out of financial contracts. Financial contracts should be exempt from any stay under the insolvency law that applies to the enforcement of a security interest.

Participation by creditors

(126) The insolvency law should specify that creditors, both secured and unsecured, are entitled to participate in insolvency proceedings and identify what that participation may involve in terms of the functions that may be performed.

Right to be heard and to request review

(137) The insolvency law should specify that a party in interest has a right to be heard on any issue in the insolvency proceedings that affects its rights, obligations or interests. For example, a party in interest should be entitled:

- (a) To object to any act that requires court approval;
- (b) To request review by the court of any act for which court approval was not required or not requested; and
- (c) To request any relief available to it in insolvency proceedings.

Right of appeal

(138) The insolvency law should specify that a party in interest may appeal from any order of the court in the insolvency proceedings that affects its rights, obligations or interests.

*Reorganization plan**Approval by classes*

(150) Where voting on approval of the plan is conducted by reference to classes, the insolvency law should specify how the vote achieved in each class would be treated for the purposes of approval of the plan. Different approaches may be taken, including requiring approval by all classes or approval by a specified majority of the classes, but at least one class of creditors whose rights are modified or affected by the plan must approve the plan.

(151) Where the insolvency law does not require a plan to be approved by all classes, the insolvency law should address the treatment of those classes which do not vote to approve a plan that is otherwise approved by the requisite classes. That treatment should be consistent with the grounds set forth in recommendation 152.

Confirmation of an approved plan

(152) Where the insolvency law requires court confirmation of an approved plan, the insolvency law should require the court to confirm the plan if the following conditions are satisfied:

- (a) The requisite approvals have been obtained and the approval process was properly conducted;
- (b) Creditors will receive at least as much under the plan as they would have received in liquidation, unless they have specifically agreed to receive lesser treatment;
- (c) The plan does not contain provisions contrary to law;
- (d) Administrative claims and expenses will be paid in full, except to the extent that the holder of the claim or expense agrees to different treatment; and
- (e) Except to the extent that affected classes of creditors have agreed otherwise, if a class of creditors has voted against the plan, that class shall receive under the plan full recognition of its ranking under the insolvency law and the distribution to that class under the plan should conform to that ranking.

Challenges to approval (where there is no requirement for confirmation)

(153) Where a plan becomes binding on approval by creditors, without requiring confirmation by the court, the insolvency law should permit parties in interest, including the debtor, to challenge the approval of the plan. The insolvency law should specify criteria against which a challenge can be assessed, which should include:

- (a) Whether the grounds set forth in recommendation 152 are satisfied; and
- (b) Fraud, in which case the requirements of recommendation 154 should apply.

Secured claims

(172) The insolvency law should specify whether secured creditors are required to submit claims.

Valuation of secured claims

(179) The insolvency law should provide that the insolvency representative may determine the portion of a secured creditor's claim that is secured and the portion that is unsecured by valuing the encumbered asset.

*Priority of claims**Secured claims*

(188) The insolvency law should specify that secured claims should be satisfied from the encumbered asset in liquidation or pursuant to a reorganization plan, subject to claims that are superior in priority to the secured claim, if any. Claims superior in priority to secured claims should be minimized and clearly set forth in the insolvency law. To the extent that the value of the encumbered asset is insufficient to satisfy the secured creditor's claim, the secured creditor may participate as an ordinary unsecured creditor.

B. Additional insolvency recommendations of the guide on secured transactions

Applicable law in insolvency proceedings

171. The insolvency law should provide that, notwithstanding the commencement of insolvency proceedings, the creation, effectiveness against third parties, priority and enforcement of a security right are governed by the law that would be applicable in the absence of the insolvency proceeding. This recommendation does not affect the application of any insolvency rules, including any rules relating to avoidance, priority or enforcement of security rights.

[Note to the Working Group: The Working Group may wish to note that the commentary will clarify the relationship between this recommendation and recommendations 30 and 31 of the Insolvency Guide. The commentary will also explain that this recommendation refers to insolvency rules without regard to whether they are characterized for any purpose as procedural, substantive, jurisdictional or otherwise.]

Assets subject to an acquisition security right (unitary approach)

172. The insolvency law should provide that, in the case of insolvency proceedings with respect to the grantor, assets subject to an acquisition security right are treated in the same way as assets subject to security rights generally.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that, in line with recommendation 178, insolvency law would recognize any special priority granted to acquisition security rights over non-acquisition security rights under secured transactions law (e.g. the priority under recommendations 185 and 186).]

Assets subject to an ownership right under a retention-of-title device (non-unitary approach)**Alternative A**

172. The insolvency law should provide that, in the case of insolvency proceedings with respect to a buyer, financial lessee or grantor, assets subject to rights under a retention-of-title device are treated in the same way as assets subject to a security right.

Alternative B

172. The insolvency law should provide that, in the case of insolvency proceedings with respect to a buyer, financial lessee or grantor, assets subject to rights under a retention-of-title device are treated as third-party owned assets under the *UNCITRAL Legislative Guide on Insolvency Law*.

Receivables subject to an outright transfer before commencement

173. The insolvency law should provide that, if the debtor makes an outright transfer of a receivable before the commencement of the debtor's insolvency proceedings, the receivable is treated in the same way that the insolvency law would treat an asset that has been the subject of an outright transfer by the debtor before commencement. Like a pre-commencement transfer by the debtor of any other asset, the outright transfer of the receivable would be subject to any relevant avoidance rules of the insolvency law.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that the Guide brings an outright transfer of a receivable (i.e. a transfer of a receivable not for security) within the scope of the Guide and defines a "security right" to include an outright transfer of a receivable. In referring to an outright transfer, the Guide does not affect the application of any rule under law, other than the insolvency law, by which a transaction may be re-characterized as a transfer for security even though the parties denominated the transaction as an outright transfer. In the event of such a re-characterization, the transfer would not qualify as an outright transfer for purposes of the Guide.]

If a security right granted by the debtor before the commencement of the debtor's insolvency proceeding consists, under law other than the insolvency law, of an outright transfer of a receivable, the insolvency law should treat the outright transfer of the receivable as it would treat a pre-commencement transfer by the debtor of any other asset where the transfer qualifies as an outright transfer under law other than the insolvency law. The receivable that is the subject of the outright transfer, like any other

asset transferred outright by the debtor before the commencement of the insolvency proceeding, should not be included in the insolvency estate of the debtor (see generally Insolvency Guide recommendation 35, subparagraph (a)).

However, as with the pre-commencement outright transfer by the debtor of any other asset and, indeed, as with any other pre-commencement transaction, the outright transfer of the receivable is nevertheless subject to the avoidance rules of the insolvency law (see Insolvency Guide recommendation 88). For example, the transfer may be avoided, and the receivable may be brought into the insolvency estate, if: (a) the transfer were not effective against third parties at the time of commencement of the insolvency proceeding; (b) the transfer could be avoided under the avoidance rules of the insolvency law relating to undervalued transactions; or (c) in the event that the transfer occurred on one date but was not made effective against third parties until a later date outside of any grace period and during the suspect transfer period, under the avoidance rules of the insolvency law relating to suspect transfers.

If the receivable is not in the insolvency estate and is not brought into the estate under the avoidance rules of the insolvency law, then, because the transferee is the true owner of the receivable, any stay arising under the insolvency law should generally not apply to the collection of the receivable by the transferee and the insolvency law should generally not apply to the receivable or to the transferee's collection of the receivable. Nevertheless, if, pursuant to a contract in effect at the time of the commencement of the insolvency proceeding, the debtor has been engaged by the transferee to collect the receivable for the benefit of the transferee, any stay under the insolvency law that is applicable with respect to contracts with the debtor generally (and thus applicable to that engagement contract) would, on that basis and notwithstanding the transferee's ownership of the receivable, prevent the transferee from collecting the receivable or otherwise interfering with the engagement contract until the termination of the stay as to the engagement contract or the rejection by the debtor of the engagement contract.]

Assets acquired after commencement

174. Except as provided in recommendation 175, the insolvency law should provide that an asset of the estate acquired after the commencement of insolvency proceedings is not subject to a security right created by the debtor before the commencement of the insolvency proceeding.

175. The insolvency law should provide that an asset of the estate acquired after the commencement of insolvency proceedings with respect to the debtor is subject to a security right created by the debtor before the commencement of the insolvency proceedings to the extent the asset is proceeds (whether cash or non-cash) of an encumbered asset that was an asset of the debtor before commencement.

Automatic termination clauses in insolvency proceedings

176. If the insolvency law provides that a contract clause that, upon the commencement of insolvency proceedings or the occurrence of another insolvency-related event, automatically terminates any obligation under a contract or accelerates the maturity of any obligation under a contract, is unenforceable as against the insolvency representative or the debtor, the insolvency law should also provide that such provision does not render unenforceable or invalidate a contract clause relieving a creditor from an obligation to make a loan or otherwise extend credit or other financial accommodations to the benefit of the debtor.

Effectiveness of a security right in insolvency proceedings

177. The insolvency law should provide that, if a security right is effective against third parties at the time of the commencement of insolvency proceedings, action may be taken after the commencement of the insolvency proceedings to continue, preserve or maintain the effectiveness against third parties of the security right to the extent and in the manner permitted under the secured transactions law.⁵⁷

Priority of a security right in insolvency proceedings

178. The insolvency law should provide that, if a security right is entitled to priority under law other than the insolvency law, the priority continues unimpaired in an insolvency proceeding except if, pursuant to the insolvency law, another claim is given priority. Such exceptions should be minimal and clearly set forth in the insolvency law. This recommendation is subject to recommendation 188 of the *UNCITRAL Legislative Guide on Insolvency Law*.

[Note to the Working Group: The Working Group may wish to note that commentary will provide examples of exceptions, such as post-commencement priority financing and privileged claims.]

Effect of a subordination agreement in insolvency proceedings

179. The insolvency law should provide that, if a holder of a security right in an asset of the insolvency estate subordinates its priority unilaterally or by agreement in favour of any existing or future competing claimant, such subordination is binding in insolvency proceedings with respect to the debtor.

[Note to the Working Group: The Working Group may wish to note that recommendation 75 sets forth the general rule on subordination applicable in the absence of insolvency proceedings. The Working Group may wish to consider that: "The general principle in insolvency of recognizing pre-commencement priorities should be interpreted to include priorities based upon a subordination agreement, provided that the agreement is not to provide a ranking higher than would otherwise be accorded to the particular creditor under the applicable law." (see Insolvency Guide, V, B, 1, para. 59, page 268).]

Costs and expenses of maintaining value of the encumbered asset in insolvency proceedings

180. The insolvency law should provide that the insolvency representative is entitled to recover on a first priority basis from the value of an encumbered asset reasonable costs and expenses (including overhead as appropriate) incurred by the insolvency representative in maintaining, preserving or increasing the value of the encumbered asset for the benefit of the secured creditor.

⁵⁷ See footnote to recommendation 46, subparagraph (b), of the Insolvency Guide, which provides that:

"If law other than the insolvency law permits those security interests to be made effective within certain specified time periods, it is desirable that the insolvency law recognize those periods and permit the interest to be made effective where the commencement of insolvency proceedings occurs before expiry of the specified time period. Where law other than the insolvency law does not include such time periods, the stay applicable on commencement would operate to prevent the security interest being made effective."

Valuation of encumbered assets in reorganization proceedings

181. The insolvency law should provide that, in determining the liquidation value of encumbered assets in reorganization proceedings, consideration should be given to the use of those assets and the purpose of the valuation. The liquidation value of those assets may be based on their value as part of a going concern.

[Note to the Working Group: The Working Group may wish to note that the commentary will note that the Insolvency Guide commentary provides the same rule for all assets (see para. 66, part two, chapter II, section B). The commentary on this chapter will make clear that, under recommendation 152 (b) of the Insolvency Guide, creditors in a reorganization proceeding will receive at least as much as they would have received in liquidation, unless they have specifically agreed to receive lesser treatment.]

XII. Acquisition financing devices⁵⁸**A. Unitary approach to acquisition financing devices****Purpose**

The purpose of the provisions of the law on acquisition financing devices is:

- (a) To recognize the importance and facilitate the use of acquisition financing as a source of affordable credit, in particular for small- and medium-size businesses;
- (b) To provide for equal treatment of all providers of acquisition financing, by applying to them the general regime governing security rights; and
- (c) To facilitate secured transactions in general by creating transparency with respect to acquisition financing devices.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that subparagraph (c) has been added in the purpose section of this Chapter since the lack of transparency with respect to acquisition financing in those jurisdictions where acquisition financing devices are not subject to a registration requirement is often a serious impediment to non-acquisition inventory and equipment financing (as well as receivables financing in jurisdictions that recognize extended retention-of-title arrangements). Creating transparency would significantly encourage these types of financing.]

Equivalence of an acquisition security right to a security right

182. The law should provide that an acquisition security right is a security right. Thus, the provisions of the law governing a security right generally, as supplemented by the specific provisions of the law on acquisition financing devices, should apply equally to all acquisition security rights.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that the characterization of an acquisition security right as a security right, which means that the acquisition secured creditor is the secured creditor and the grantor is the owner of the encumbered assets, applies only to the secured financing aspect of the transaction. While the acquisition security right

⁵⁸ See A/CN.9/WG.VI/WP.24/Add.5.

secures the grantor's obligation to pay the balance of the purchase price, the underlying transaction is still a sale or a financial lease. Therefore, the law of sales or leases continues to apply to other aspects of the transaction (such as warranties of title and quality, right to re-sell or sub-lease, taxation, insurance and accounting). The commentary will also explain that, if, for example, a secured creditor under an acquisition financing device sold equipment to a buyer which was defective, the buyer would be able to rely on the terms of the contract including other relevant law to pursue such remedies as may be available to a buyer by that other law, such as rejection of the goods and repudiation of the contract by the buyer.]

Creation of an acquisition security right

183. The law should provide that an acquisition security right is created [in the same way as a security right under recommendation 13] [by agreement between the grantor and the secured creditor that need not be concluded in or evidenced by writing and is not subject to any other requirement as to form. It may be proved by any means, including witnesses].

[Note to the Working Group: The Working Group may wish to note that recommendation 183 (unitary approach) includes the same alternatives as recommendation 183 (non-unitary approach), so as to implement the equivalence principle. However, if the Working Group decides to retain the creation requirements applicable under the general recommendation 13, recommendation 183 may not be necessary as it would repeat the general rule.]

Effectiveness of an acquisition security right against third parties

184. Except as otherwise provided in recommendation 185, the law should provide that an acquisition security right becomes effective against third parties by registration of a notice of the right in the general security rights registry in the same manner as provided in the provisions of this law governing third-party effectiveness with respect to security rights in the same kind of encumbered assets. If the notice is registered not later than [specify a short time period, such as 20 or 30 days] days from the time of delivery of the goods to the grantor, the right is effective against third parties whose rights arose between the time the acquisition security right was created and its registration, as well as against third parties whose rights were registered subsequently. If the notice is registered after the expiration of that period, the acquisition security right is effective against third parties from the time the notice is registered.

Exceptions to the requirement of registration with respect to an acquisition security right

185. The law should provide that an acquisition security right in consumer goods becomes effective against third parties upon its creation. This provision does not affect security rights made effective against third parties by possession or by registration in a specialized registry or notation on a title certificate.

Priority of an acquisition security right in goods other than inventory or consumer goods as against an earlier registered non-acquisition security right in the same goods

186. The law should provide that an acquisition security right in goods other than inventory or consumer goods has priority as against a non-acquisition security right in the same goods (even if a notice of that security right was registered in the general security rights registry before registration of a notice of the acquisition security right), provided that:

- (a) The acquisition financier retains possession of the goods; or
- (b) Notice of the acquisition security right is registered within a period of [the same number of days specified in recommendation 184] from the delivery of the goods to the grantor.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that a common situation in which this priority conflict arises is where a pre-existing secured creditor has a security right in all of the grantor's existing and future-acquired goods and another creditor finances the acquisition of specific goods.]

Priority of an acquisition security right in inventory as against an earlier registered non-acquisition security right in inventory of the same kind

187. The law should provide that an acquisition security right in inventory of the grantor has priority as against a non-acquisition security right in the grantor's inventory of the same kind (even if that security right became effective against third parties before the acquisition security right became effective against third parties), provided that:

- (a) The acquisition financier retains possession of the goods; or
- (b) Before delivery of the inventory to the grantor:
 - (i) A notice of the acquisition security right is registered in the general security rights registry; and
 - (ii) The holder of the earlier registered security right is notified in writing by the acquisition financier that the acquisition financier intends to enter into one or more acquisition financing transactions with respect to the inventory described in the notification. The notification should describe the inventory sufficiently to inform the holder of the earlier-registered security right of the inventory being financed.

Priority of an acquisition security right as against the right of a judgement creditor

188. The law should provide that, notwithstanding recommendation 86, an acquisition security right that is made effective against third parties within the grace period provided in recommendation 184 has priority as against the rights of an unsecured creditor that, under law other than this law:

- (a) Obtained a judgement or provisional court order against a grantor after the creation of the acquisition security right; and

(b) Took the steps necessary to acquire rights in encumbered assets of the grantor by reason of the judgement or provisional court order.

Priority of an acquisition security right in attachments to immovable property as against an earlier registered security right in the immovable property

189. The law should provide that an acquisition security right in tangibles that are to become attachments to immovable property, registered in the immovable property registry within [specify a short time period, such as 20-30 days] days after the tangibles become attachments, has priority as against an existing encumbrance in the related immovable property (other than an encumbrance securing a loan financing the construction of the immovable property).

One or more acquisition financing transactions

190. The law should provide that a single notification to holders of earlier registered non-acquisition security rights may cover encumbered assets acquired through one or more acquisition financing transactions between the same parties, without those transactions having to be identified in the notification. However, the notification should be effective only for acquisition security rights in encumbered assets delivered within a period of [specify time, such as five years] years after the notification is given.

Priority of an acquisition security right in proceeds of goods other than inventory or consumer goods

191. The law should provide that the priority, provided under recommendation 186 (unitary approach), for an acquisition security right in goods other than inventory or consumer goods as against an earlier registered non-acquisition security right in the same goods extends to the proceeds of such goods.

Priority of an acquisition security right in proceeds of inventory

192. The law should provide that the priority, provided under recommendation 187 (unitary approach), for an acquisition security right in inventory as against an earlier registered security right in inventory of the same kind extends to the proceeds of such inventory [other than receivables]. However, the acquisition financier must notify earlier registered financiers with a security right in assets of the same kind as the proceeds before delivery of the inventory to the grantor or, at the latest, at the time the proceeds arise.

[Note to the Working Group: The Working Group may wish to reconsider the question whether the priority of recommendation 192 should be extended to proceeds consisting of receivables. The extension of the priority to receivables would significantly discourage receivables financing. In most instances, there may be no practical way for a receivables financier to determine which of the grantor's receivables would be subject to the acquisition financier's paramount security right. The result might be that the receivables financier may simply stop financing when it receives the notice contemplated by this recommendation. This possibility will either discourage receivables financing or, if the receivables financier agrees to continue financing only if there are no inventory acquisition financing devices, it will discourage acquisition financing. Neither possibility is consistent with the objectives of the Guide. A better solution would be for the priority of the inventory

financier not to extend to proceeds consisting of receivables so that the receivables financier is encouraged to provide credit against the receivables and the proceeds of that credit may be used by the grantor to pay the inventory financier. The Working Group may wish to note that, in most jurisdictions that recognize retention-of-title arrangements, the property right of the retention-of-title seller in the inventory sold does not extend to receivables arising from the sale of that inventory.]

Enforcement of an acquisition security right

193. The law should provide that the provisions of the law on default and enforcement apply to the enforcement of an acquisition security right.

[Note to the Working Group: The Working Group may also wish to consider additional text along the following lines:

“In the case of an ownership right under a retention-of-title device, if notice of the right is required to be registered in the security rights registry, but is not registered, or is registered only after the expiration of the time specified in recommendation 184, the retention-of-title seller, financial lessor or purchase money lender is entitled to repossess the goods only if they are still in the possession of the buyer, financial lessee or grantor and takes the goods back subject to any security rights granted by the buyer, financial lessee or grantor. However, in the case of a late registration, if the notice is registered before the sale of the goods by the original buyer, financial lessee or grantor, the seller, financial lessor or purchase-money lender may repossess the goods in the possession of the subsequent buyer, other than [a buyer of inventory in the ordinary course of business of the seller and any other person whose rights to the inventory derive from that buyer (even if such buyer or other person has knowledge of the existence of the security right)] [a good faith buyer]”.]

Acquisition security rights in insolvency proceedings

[Note to the Working Group: The Working Group may wish to note that the recommendations that deal with acquisition financing devices in insolvency proceedings are contained in the insolvency chapter.]

Applicable law to an acquisition security right

194. The law should provide that the provisions of this law on conflict of laws apply to acquisition security rights.

B. Non-unitary approach to acquisition financing devices

[Note to the Working Group: The Working Group may wish to note that, at its thirty-ninth session, the Commission approved the substance of the unitary approach and referred the non-unitary approach to the Working Group for further discussion (see A/61/17, para. 69).]

Purpose (non-unitary approach)

The purpose of the provisions of the law on retention-of-title devices is:

(a) To recognize the importance and facilitate the use of retention-of-title devices as a source of affordable credit, in particular for small- and medium-size businesses;

(b) To provide for equal treatment of all retention-of-title sellers, financial lessors and purchase-money lenders and apply to retention-of-title devices particular rules so as to produce outcomes that are functionally equivalent to the outcomes produced by a security rights regime [to the extent compatible with the regime governing the enforcement of ownership rights]; and

(c) To facilitate the use of security rights by creating transparency with respect to retention-of-title devices.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that a separate set of recommendations has been prepared for States that may wish to adopt a non-unitary approach with respect to retention-of-title devices. In order to use the relevant terminology and to reflect a slight difference in the issue, where necessary, separate titles have been added to the recommendations of the non-unitary approach. In addition, separate (but the same) numbers have been included to the recommendations of the non-unitary approach not only to facilitate their reading but also their possible later reproduction as a separate, consolidated set of recommendations at the end of the recommendations of the unitary approach.]

The Working Group may wish to note that the commentary will explain that the words “to the extent compatible with the regime governing the enforcement of ownership rights” have been added to align the purpose section with recommendations 172, alternative B (non-unitary approach), and 193, alternative B (non-unitary approach), on the enforcement of retention-of-title devices in and outside of insolvency proceedings. Under this alternative of the non-unitary approach, the treatment of the enforcement of acquisition security rights in and outside of insolvency proceedings would not be fully equivalent to the treatment of security rights but would rather conform to the treatment of enforcement of ownership rights (for a discussion of the differences, see A/CN.9/WG.VI/WP.17, paras. 39-42; see also the note to recommendation 193, non-unitary approach, alternative B). The commentary will discuss the consequences of such an approach (e.g. lack of uniformity, potential impact on the availability of credit) to assist States in making a choice.]

Equivalence of an ownership right under a retention-of-title device to a security right

182. If the law excludes ownership rights under retention-of-title devices from the definition of “security right”, the law should provide that a purchase-money lender has the same rights as a seller in a retention-of-title transaction. The provisions of this law applicable to security rights, as supplemented by the specific provisions applicable to ownership rights under retention-of-title devices in this chapter, apply to all retention-of-title devices in a manner that preserves the functional equivalence of rights under retention-of-title devices to security rights [to

the extent compatible with the relevant ownership regime in the case of enforcement].

[Note to the Working Group: The Working Group may wish to note that, in order to implement its decision to treat all providers of acquisition financing equally (see A/CN.9/574, para. 35), under the non-unitary approach, language has been added to recommendation 182 (non-unitary approach) to ensure that purchase-money lenders are treated as owners. The commentary will explain the words “to the extent compatible with the relevant ownership regime in the case of enforcement” and their consequences with respect to the enforcement of an ownership right under a retention-of-title device in and outside insolvency (see recommendations 172, alternative B (non-unitary approach), and 193, alternative B (non-unitary approach)).]

Creation of an ownership right under a retention-of-title device

183. The law should provide that an ownership right under a retention-of-title device is created [in the same way as a security right under recommendation 13] [by an agreement between the buyer, financial lessee or grantor and the seller, financial lessor or purchase-money lender that need not be concluded in or evidenced by writing and is not subject to any other requirement as to form. It may be proved by any means, including witnesses].

[Note to the Working Group: The Working Group may wish to note that, in order to ensure that all issues addressed by recommendation 13 are covered, recommendation 183 (non-unitary approach) refers to creation, although no new ownership right is created by a retention-of-title device. The Working Group may wish to consider alternative wording or an explanation for the commentary.]

Recommendation 183 (non-unitary approach) provides for two alternatives, one based on article 11 of the United Nations Sales Convention (“CISG”) and another based on the form requirements foreseen in recommendation 13 of the Guide.

With regard to recommendation 183 (non-unitary approach), the Working Group may wish to consider additional wording along the following lines:

“The law should also provide that a buyer, financial lessee or grantor has the power to grant a security right in the goods sold or leased notwithstanding the seller’s, lessor’s or purchase-money lender’s ownership rights.”]

Effectiveness of an ownership right under a retention-of-title device against third parties

184. Except as otherwise provided in recommendation 185, the law should provide that an ownership right under a retention-of-title device becomes effective against third parties by registration of a notice of the right in the general security rights registry in the same manner as provided in the provisions of this law governing third-party effectiveness with respect to security rights in the same kind of encumbered assets. If the notice is registered not later than [specify a short time period, such as 20 or 30 days] days from the time of delivery of the goods to the buyer, financial lessee or grantor, the right is effective against third parties whose rights arose between the time the retention of title device was concluded and its registration, as well as against third parties whose rights were registered subsequently. If the notice is registered after the expiration of that period, the

ownership right under the retention-of-title device is effective against third parties from the time the notice is registered.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that, in the case of a retention-of-title device, effectiveness against third parties and priority over competing claimants means that the ownership right of the retention-of-title seller, financial lessor or purchase-money lender to the goods may be asserted against third parties, including competing claimants, claiming through the buyer, lessee or grantor.]

Exceptions to the requirement of registration with respect to an ownership right under a retention-of-title device

185. The law should provide that an ownership right under a retention-of-title device relating to consumer goods becomes effective against third parties upon its creation. This provision does not affect rights made effective against third parties by possession or by registration in a specialized registry or notation on a title certificate.

[Note to the Working Group: The Working Group may wish to consider whether all security rights in consumer goods (perhaps, with the exception of security rights in consumer goods that become attachments to immovable property) should be exempt from the requirement of registration (see note to recommendation 41).]

Priority of an ownership right under a retention-of-title device in goods other than inventory or consumer goods as against an earlier registered non-acquisition security right in the same goods

186. The law should provide that an ownership right under a retention-of-title device in goods other than inventory or consumer goods has priority as against a security right in the same goods (even if a notice of that security right was registered in the general security rights registry before registration of a notice of the ownership right under the retention-of-title device), provided that:

(a) The seller, financial lessor or purchase-money lender retains possession of the goods; or

(b) Notice of the ownership right under the retention-of-title device is registered within a period of [the same number of days specified in recommendation 184] from the delivery of the goods to the buyer, financial lessee or grantor.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain the impact of recommendations 186 and 187 in non-unitary systems along the lines described in document A/CN.9/588, paragraph 60. The Working Group may also wish to consider whether subparagraph (a) could apply to a retention-of-title device in view of the fact that normally possession of the goods would be delivered to the buyer, financial lessee or grantor.]

Priority of an ownership right under a retention-of-title device in inventory as against an earlier registered non-acquisition security right in inventory of the same kind

187. The law should provide that an ownership right under a retention-of-title device in inventory has priority as against a security right in inventory of the same

kind (even if that right became effective against third parties before the ownership right under the retention-of-title device became effective against third parties), provided that:

- (a) The seller, the financial lessor or the purchase-money lender retains possession of the goods; or
- (b) Before delivery of the inventory to the buyer, financial lessee or grantor:
 - (i) A notice of the ownership right under the retention-of-title device is registered in the general security rights registry; and
 - (ii) The holder of an earlier registered security right is notified in writing that the seller, financial lessor or purchase-money lender intends to enter into one or more retention-of-title transactions with respect to the inventory. The notification should describe the inventory sufficiently to inform the holder of an earlier registered security right of the inventory being financed.

[Note to the Working Group: The Working Group may wish to consider whether subparagraph (a) could apply to a retention-of-title transaction or financial lease in view of the fact that normally possession of the goods would be delivered to the buyer, financial lessee or grantor. The Working Group may also wish to consider whether the registry should notify automatically inventory financiers on record (see A/61/17, para. 67). It should be noted that such an approach would require the registry to distinguish inventory financiers from other financiers. In addition, such an approach would require the grantor to ensure that the registry has given such notice before the grantor delivers the inventory to the acquisition financier.]

Priority of an ownership right under a retention-of-title device over the right of a judgement creditor

188. The law should provide that, notwithstanding recommendation 86, an ownership right under a retention-of-title device that is made effective against third parties within the grace period provided in recommendation 184 has priority as against the rights of an unsecured creditor that, under law other than this law:

- (a) Obtained a judgement against a buyer, financial lessee or grantor after the creation of the ownership right under the retention-of-title device; and
- (b) Took the steps necessary to acquire rights in the relevant assets of the buyer, financial lessee or grantor by reason of the judgement.

[Note to the Working Group: The Working Group may wish to consider that an acquisition security right that became effective against third parties during the relevant grace period should not lose to the rights of a judgement creditor described in this recommendation, whose interest in the encumbered asset arose after the creation of the acquisition security right but before it became effective against third parties. If this were not the case, utilizing the grace period would be too risky for acquisition financiers. The Working Group may wish to consider this recommendation together with recommendation 86.]

Priority of ownership rights under retention-of-title devices with respect to attachments to immovable property as against earlier registered security rights in the immovable property

189. The law should provide that an ownership right under a retention-of-title device in tangibles that are to become attachments to immovable property, registered in the immovable property registry within [specify a short time period, such as 20-30 days] days after the tangibles become attachments, has priority as against an existing encumbrance in the related immovable property (other than an encumbrance securing a loan financing the construction of the immovable property).]

[Note to the Working Group: The Working Group may wish to note that the priority introduced by this recommendation would not prejudice the rights of a holder of an existing mortgage on the related immovable property because the mortgagee would normally not rely upon subsequently added attachments. However, the priority created by this rule should not operate to grant priority over construction lenders that are presumed to rely upon all goods that become attachments to immovable property during the course of construction.]

One or more retention-of-title devices

190. The law should provide that a single notification to holders of earlier registered security rights may cover assets acquired through one or more retention-of-title devices between the same parties, without those devices having to be identified in the notification. However, the notification should be effective only for ownership rights in assets delivered within a period of [specify time, such as five years] years after the notification is given.

Priority of an ownership right under a retention-of-title device in proceeds of goods other than inventory or consumer goods

191. The law should provide that the priority, provided under recommendation 186 (non-unitary approach), for an ownership right under a retention-of-title device in goods other than inventory extends to the proceeds of such goods.

Priority of an ownership right under a retention-of-title device in proceeds of inventory

192. The law should provide that the priority of an ownership right under a retention-of-title device in inventory provided under recommendation 186 (non-unitary approach) extends to the proceeds of such inventory [other than receivables]. However, the retention-of-title seller, financial lessor or purchase-money lender must notify earlier-registered financiers with a security right in assets of the same kind as the proceeds before actual delivery of the inventory to the buyer, financial lessee or grantor, or, at the latest, at the time the proceeds arise.

Enforcement of an ownership right under a retention-of-title device**Alternative A**

193. The law should provide that, in the case of default, a retention-of-title device must be enforced in such a manner that:

(a) The same principles and objectives as those governing enforcement of security rights generally are complied with; and

(b) The same results are obtained.

[Note to the Working Group: The Working Group at its eighth session recommended formulation of the non-unitary approach along the lines set out above.]

Alternative B

193. The law should provide that the provisions of the law on default and enforcement apply to the enforcement of ownership rights under retention-of-title devices to the extent compatible with the regime applicable to the enforcement of ownership rights.

[Note to the Working Group: The Working Group may wish to note that the last words of the second alternative under a non-unitary approach would conform the non-unitary approach to the existing law in each State on the enforcement of ownership rights rather than to the enforcement recommendations of the Guide. For example, in some jurisdictions this would mean that, upon default, a seller that retained title and obtained possession of the assets would be permitted to retain, rather than dispose of, the assets and would not have to account to the buyer for any surplus of the value of those assets over the unpaid portion of the purchase price and would not have a claim against the buyer with respect to the unpaid portion of the purchase price (for a discussion of the differences, see A/CN.9/WG.VI/WP.17, paras. 39-42; see also the second alternative of the non-unitary approach recommendation on the enforcement of ownership rights under retention-of-title devices in insolvency proceedings below).]

Ownership rights under retention-of-title devices in insolvency proceedings

[Note to the Working Group: The Working Group may wish to note that the recommendations that deal with acquisition financing devices in insolvency proceedings are contained in the insolvency chapter.]

Applicable law to an ownership right under a retention-of-title device

194. The law should provide that the provisions of this law on conflict of laws apply to retention-of-title devices.

XIII. Conflict of laws^{*59}

Purpose

The purpose of conflict-of-laws rules is to determine the law applicable to each of the following issues: the creation of a security right; the pre-default rights and obligations between the secured creditor and the grantor; the effectiveness of a security right against third parties; the priority of a security right as against the rights of competing claimants; and the enforcement of a security right.⁶⁰

These rules are also applicable to:

(a) “Security rights” within the scope of the law, which includes rights under retention-of-title sales and financial leases, as well as outright transfers of receivables; and

(b) In States that enact a non-unitary system with respect to acquisition financing devices, the rights of a seller or a financial lessor of goods that retains title to the goods.

A. General recommendations

Law applicable to a security right in tangible property⁶¹

195. The law should provide that, except as otherwise provided in recommendations 196 and 209, the creation, the effectiveness against third parties and the priority as against the rights of competing claimants of a security right in tangible property are governed by the law of the State in which the encumbered asset is located. However, with respect to security rights in tangible property of a type ordinarily used in more than one State, the law should provide that such issues are governed by the law of the State in which the grantor is located. [With respect to security rights in the type of tangible property mentioned in the preceding sentence that is subject to a title registration system, the law should provide that such issues are governed by the law of the State under the authority of which the registry is maintained.]

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that the application of recommendation 195 to negotiable instruments and rights to payment of funds credited to a bank account is subject to the limited exception provided in recommendation 209 that the law of the grantor's location determines in specified circumstances whether the effectiveness against third parties has been achieved by registration. The commentary will also explain that recommendation 196 provides an additional option for the creation and third-party effectiveness of security rights in goods in transit and export goods.]

The Working Group may wish to note that the commentary will explain that “tangible property of a type ordinarily used in more than one State” refers to

* The recommendations on conflict of laws were prepared in close cooperation with the Hague Conference on Private International Law.

⁵⁹ See A/CN.9/WG.VI/WP.24.

⁶⁰ The meaning of these terms is elaborated upon in chapters IV, V, VII, VIII and X.

⁶¹ See A/CN.9/611/Add.1, recommendation 136.

mobile goods, such as motor vehicles. The same term in the bracketed sentence in recommendation 195 refers to mobile goods, such as ships and aircraft.

In addition, the Working Group may wish to consider whether a rule along the lines of recommendation 209 should apply to security rights in tangible assets covered in recommendation 195. If that approach were to be followed, if the grantor's location provided for third-party effectiveness by registration, the only law applicable to third-party effectiveness of security rights in tangible assets other than by possession would be the law of the grantor's location and not the law of the location of the assets.

The Working Group may wish to note that a security right may be created in goods either pursuant to recommendation 12 or by the creation of a security right in a negotiable document representing those goods pursuant to recommendation 27. In either case, recommendation 195 provides that the creation, third-party effectiveness and priority of the security right are governed by the law of State of the location of the goods or document, as applicable. Because goods in transit and export goods, by their nature, move from State to State and, therefore, the location of the goods at any particular moment might be fortuitous and temporary, recommendation 196 provides an alternative method for creation and third-party effectiveness of a security right in such goods referring to the law of the State of the ultimate destination of the goods, provided that the goods reach that destination within a reasonable period of time. Recommendation 196 thus addresses the problems that could result from unwavering adherence to the "location of the tangible asset rule" in the context of goods whose location will certainly change as a result of the very nature of the financing transaction.

The Working Group may also wish to note that, in many financing transactions involving negotiable documents, the location of the negotiable document may change, as, for example, where a bill of lading is sent from the consignor to the consignee or the secured creditor. In such transactions, at any particular time the negotiable document might be located in a different State than the goods that it represents, even though the goods and the negotiable document will ultimately be located in the same State. In order to address the question of the law applicable to security rights in goods covered by a negotiable document, at the tenth session of the Working Group the suggestion was made that the practical issue with respect to the goods that is addressed by recommendation 196 might also be present for the negotiable document representing those goods and that, accordingly, there may be some advantage in broadening the rule in recommendation 196 to cover negotiable documents (see A/CN.9/603, para. 60).

Thus, the Working Group may wish to consider extending the application of recommendation 196 to negotiable documents. In that connection, the Working Group may wish to take into consideration that, under recommendations 97 and 98, the priority of a security right in goods covered by a negotiable document is always subject to the law of the location of the document. If the applicable law is the law of a State that has enacted the recommendations of the Guide, under recommendation 195, the security right in the goods that became effective against third parties as a result of the security right in the negotiable document becoming effective against third parties will have priority over a security right in the goods that became effective against third parties by another method. The Working Group may also wish to note that, under recommendation 200, the enforcement of the security right in the goods or the document is always subject to the law of the State where enforcement

takes place or the law governing the security agreement, depending on which alternative is retained (for this note, see A/CN.9/611/Add.1, note to recommendation 136).]

Law applicable to a security right in goods in transit and export goods

196. The law should provide that a security right in tangible property (other than negotiable instruments or negotiable documents) in transit or to be exported from the State in which it is located at the time of the creation of the security right may also be created and made effective against third parties under the law of the State of the ultimate destination, provided that the property reaches that State within a short time period of [to be specified] days after the time of creation of the security right.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that a security right in goods in transit and export goods can be created and made effective against third parties, under recommendation 195, in accordance with the law of the State of their location at the time of creation or, under recommendation 196, in accordance with the law of the State of their ultimate destination. The commentary will also explain that the law of the State of the ultimate destination that governs creation and third-party effectiveness will apply even in the case of a contest with competing rights that were created and made effective against third parties while the export goods were located in the State of origin.]

In addition, the commentary will explain that the rule in this recommendation: (a) is applicable to encumbered assets that travel whether or not negotiable documents relating to the goods accompany the goods; (b) is not applicable to encumbered goods that do not travel, whether or not negotiable documents relating to the goods do travel; and (c) is not applicable to encumbered negotiable documents whether or not they travel (for this note, see A/CN.9/611/Add.1, note to recommendation 142).]

Law applicable to a security right in intangible property⁶²

197. The law should provide that the creation, the effectiveness against third parties and the priority as against the rights of competing claimants of a security right in intangible property are governed by the law of the State in which the grantor is located. [However, with respect to security rights in intangible property that is subject to a title registration system, the law should provide that such issues are governed by the law of the State in which [...].]

*[Note to the Working Group: The commentary will explain that this recommendation, reflecting the principle in articles 22 and 30 of the United Nations Assignment Convention, applies, for example, to receivables. The second sentence within square brackets is intended to draw the attention of the Working Group to the possibility that a different law might apply to other intangible assets that are subject to title registration, such as intellectual property rights (e.g. the *lex loci protectionis* for patents and trademarks and the *lex loci protectionis* or the *lex originis* for copyrights).]*

⁶² See A/CN.9/611/Add.1, recommendation 137.

Law applicable to a security right in proceeds

198. The law should provide that:

(a) The creation of a security right in proceeds is governed by the law [of the State whose law governs] [governing] the creation of the security right in the original encumbered asset from which the proceeds arose; and

(b) The effectiveness against third parties and the priority as against the rights of competing claimants of a security right in proceeds are governed by the same law as the law [of the State whose law governs] [governing] the effectiveness against third parties and the priority over the rights of competing claimants of a security right in original encumbered assets of the same kind as the proceeds.

Law applicable to the rights and obligations of the grantor and the secured creditor

199. The law should provide that the mutual rights and obligations of the grantor and the secured creditor with respect to the security right, whether arising from the security agreement or by law, are governed by the law chosen by them and, in the absence of a choice of law, by the law governing the security agreement.

Law applicable to the enforcement of a security right

200. Except as provided in the provisions of this law on the law applicable to the enforcement of a security right after commencement of an insolvency proceeding with respect to the grantor, the law should provide that matters affecting the enforcement of a security right are governed by

Alternative A

the law of the State where enforcement takes place.

Alternative B

the law governing the security agreement. However, possession of an encumbered asset without the consent of the person in possession may be taken by the secured creditor only in accordance with the law of the State in which that asset is located at the time the secured creditor takes possession.

[Note to the Working Group: The Working Group may also wish to note that, at its thirty-ninth session, the Commission urged the Working Group to reach agreement, if at all possible, on one of the alternatives set out in recommendations 200 and 208.]

201. The enforcement of a security right in an attachment to immovable property is governed by the law of the State where the immovable property is located.

[Note to the Working Group: The Working Group may wish to consider that recommendation 195 is sufficient with respect to the law applicable to the creation, third-party effectiveness and priority of a security right in an attachment to movable property, while recommendation 200 is sufficient for the enforcement of such a security right (for this note, see A/CN.9/WG.VI/WP.26/Add.4, note on the law applicable to the enforcement of a security right in attachments).]

Impact of insolvency on the law applicable

[Note to the Working Group: The Working Group may wish to note that the recommendations on the law applicable to the enforcement of a security right in an insolvency proceeding are contained in the chapter on insolvency (see recommendation 171).]

Meaning of “location” of the grantor

202. The law should provide that, for the purposes of the provisions of this law on conflict of laws, the grantor is located in the State in which it has its place of business. If the grantor has a place of business in more than one State, the grantor's place of business is that place where the central administration of the grantor is exercised. If the grantor does not have a place of business, reference is to be made to the habitual residence of the grantor.

Relevant time when determining location

203. The law should provide that:

(a) Except as provided in subparagraph (b) of this recommendation, references to the location of the assets or of the grantor in the provisions of this law on conflict of laws refer, for creation issues, to that location at the time of the creation of the security right and, for third-party effectiveness and priority issues, to that location at the time the issue arises;

(b) If all rights of competing claimants in an encumbered asset arose before a change in location of the asset or the grantor, references in the provisions of this law on conflict of laws to the location of the asset or of the grantor (as relevant under the recommendations in this chapter) refer, with respect to third-party effectiveness and priority issues, to the location prior to the change in location.

Continued third-party effectiveness of a security right upon change of location

204. The law should provide that, if a security right in encumbered assets is effective against third parties under the law of the State in which the encumbered assets or the grantor (as relevant under the provisions of the law on conflict of laws) are located and that location changes to this State (i.e. the State that has enacted the law), the security right continues to be effective against third parties under the law of this State for a period of [to be specified] days after the location of the encumbered assets or the grantor (as relevant under the provisions of the law on conflict of laws) has changed to this State. If the requirements of the law of this State to make the security right effective against third parties are satisfied prior to the end of that period, the security right continues to be effective against third parties thereafter under the law of this State. For the purposes of any rule of this State in which time of registration or other method of achieving third-party effectiveness is relevant for determining priority, that time is the time at which that event occurred under the law of the State in which the encumbered assets or the grantor were located before their location changed to this State.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that the application of this recommendation is not based on reciprocity, that is, it operates regardless of whether or not the State of the old location of the encumbered assets or of the grantor has enacted an equivalent

provision to cover the converse situation involving the relocation of encumbered assets or a grantor to that State. The commentary will also explain that this recommendation will apply if the asset or the grantor moves from an enacting State or a non-enacting State to an enacting State. This recommendation (or the Guide) will not apply if the asset or the grantor moves from an enacting State or a non-enacting State to a non-enacting State. Furthermore, the commentary will explain that the effect of the last sentence of this recommendation is that priority in the receiving State “relates back” to the time at which the relevant event for achieving third-party effectiveness occurred in the other State.]

Exclusion of renvoi

205. The law should provide that the reference in the provisions of the law on conflict of laws to “the law” of another State as the law governing an issue refers to the law in force in that State other than its conflict-of-laws rules.

Public policy and internationally mandatory rules

206. The law should provide that:

(a) The application of the law determined under the provisions of this law on conflict of laws may be refused by the forum only if the effects of its application would be manifestly contrary to the public policy of the forum;

(b) A forum may apply those provisions of its own law which, irrespective of rules of conflict of laws, must be applied even to international situations; and

(c) The rules in subparagraphs (a) and (b) of this recommendation do not permit the application of provisions of the law of the forum to third-party effectiveness or priority among competing claimants, unless the law of the forum is the applicable law under the provisions of this law on conflict of laws.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain the meaning of public policy and internationally mandatory rules referred to in this recommendation. Subparagraphs (a) and (b), which track the language of article 11, paragraphs 1 and 2, of the Hague Securities Convention, have been prepared pursuant to a suggestion made at the eighth session of the Working Group (see A/CN.9/588, para. 107). Subparagraph (c), which tracks the language of article 11, paragraph 3, of the Hague Securities Convention, is also in line with articles 30 to 32 of the United Nations Assignment Convention. It is intended to ensure that the certainty of the law applicable to third-party effectiveness and priority of a security right achieved with the recommendations in this chapter will not be compromised by application of the law of the forum.]

B. Asset-specific recommendations

Law applicable to receivables arising from a sale, lease or security agreement relating to immovable property

207. The law should provide that the law of the State in which the assignor is located governs the creation, third-party effectiveness and priority of a security right in a receivable arising from a sale, lease or security agreement relating to immovable property over the rights of competing claimants. However, a priority conflict involving the rights of a competing third party registered in the immovable

property registry of the State in which the immovable property is located is governed by the law of that State.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that this recommendation is designed to address the law applicable to assignments of receivables owing to the grantor under an agreement for the sale or lease of an immovable or under a security agreement over an immovable. In a number of States, it is not possible to create rights in such receivables independently of the related immovable, with the result that the effectiveness as between the parties, the third-party effectiveness and the priority of a security right in the receivables are governed by the law (and, in particular, the registry regime) that applies to the related immovable. In other States, it is possible to grant a security right in such receivables independently of the related immovable, but the secured creditor is subordinated to third-party rights that are registered against the related immovable in the immovable property registry.]

The second sentence of this recommendation is designed to preserve the application of the law of the State where the related immovable is located in order to protect third parties that rely on the registration in the immovable property registry of that State. Reference is made to rights of a competing third party as the term "competing claimant" is defined by reference to security rights in movables. Reference is also made to "rights" of such parties, since rights of third parties could include not just competing mortgagees but also assignees or buyers of the immovable or the related intangible and indeed any class of third-party right for which the immovable property regime makes provision for registration. In addition, reference is made to a right "registered in the immovable property registry" rather than "that became effective against third parties by registration", since: (a) some immovable property registries do not distinguish between inter-parties and third party effectiveness; and (b) immovable property registries do not necessarily require registration for general third-party effectiveness but only for effectiveness against third parties whose rights are also registrable in the immovable property registry (e.g. registration may not be needed for effectiveness against an insolvency administrator or a judgement creditor.)

Law applicable to a security right in a right to payment of funds credited to a bank account⁶³

208. Except as otherwise provided in recommendation 209, the law should provide that the creation, the effectiveness against third parties, the priority as against the rights of competing claimants, the rights and duties of the depositary bank with respect to the security right and the enforcement of the security right in a right to payment of funds credited to a bank account are governed by

Alternative A

the law of the State expressly stated in the account agreement as the State whose law governs the account agreement or, if the account agreement expressly provides that another law is applicable to all such issues, that other law. However, the law of the State determined pursuant to the preceding sentence applies only if the depositary bank has, at the time of the conclusion

⁶³ See A/CN.9/611/Add.1, recommendation 139.

of the account agreement, an office in that State that is engaged in the regular activity of maintaining bank accounts. If the applicable law is not determined pursuant to the preceding two sentences, the applicable law is to be determined pursuant to fallback rules based on article 5 of the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary.

[Note to the Working Group: The Working Group may wish to note that alternative A is an abbreviated version of the approach followed in articles 4.1 and 5 of the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary (“the Hague Securities Convention”). The commentary will include the detailed fallback rules in article 5 of the Hague Securities Convention with sufficient explanation.]

Alternative B

the law of the State in which the bank that maintains the bank account has its place of business. In the case of more than one place of business, reference should be made to the place where the branch maintaining the account is located.

[Note to the Working Group: The Working Group may wish to consider, as an alternative or supplementary provision, the law governing the control agreement (see A/CN.9/603, para. 77). The Working Group may also wish to note that the commentary will explain that the recommendations on the impact of insolvency on the law applicable, as well as the other general recommendations in the conflict-of-laws chapter, apply to security rights in rights to payment of funds credited to a bank account.]

Law applicable to the third-party effectiveness of a security right in specified types of asset by registration⁶⁴

209. The law should provide that, if the State in which the grantor is located recognizes registration as a method of achieving effectiveness against third parties of a security right in a negotiable instrument or a right to payment of funds credited to a bank account, the law of the State in which the grantor is located determines whether the effectiveness against third parties of a security right in such encumbered asset has been achieved by registration under the laws of that State.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that this recommendation provides that the State whose law governs the achievement of third-party effectiveness by registration with respect to security rights in the specified types of asset is the same State whose law governs the achievement of third-party effectiveness with respect to security rights in intangible property. Thus, secured creditors seeking to achieve third-party effectiveness by registration for security rights in the specified types of assets and in intangible property will need to comply with the registration system of only one State. Similarly, third parties seeking to determine whether any secured creditor is claiming a security right in the specified types of asset or in intangible property will need to search in the registration system of only one State. The commentary will also explain recommendation 209 applies only to third-party effectiveness achieved by registration (not by control or

⁶⁴ See A/CN.9/611/Add.1, recommendation 140.

any other method) and does not determine the law governing priority. In addition, the commentary will explain that, under recommendation 89, a security right in a negotiable instrument made effective against third parties by registration is subordinate to a security made effective against third parties by possession with respect to the instrument. Similarly, under recommendation 92, a security right in a right to payment of funds credited to a bank account made effective by registration is subordinate to a security right made effective by control.]

Law applicable to a security right in proceeds under an independent undertaking⁶⁵

210. The law should provide that the law of the State specified in the independent undertaking of the guarantor/issuer, confirmer or nominated person governs:

(a) The rights and duties of the guarantor/issuer, confirmer or nominated person that has received a request for an acknowledgement or that has or may pay or otherwise give value under an independent undertaking;

(b) The right to enforce a security right in proceeds under an independent undertaking against a guarantor/issuer, confirmer or nominated person; and

(c) Except to the extent otherwise provided in recommendation 212, the effectiveness against third parties and the priority as against the rights of competing claimants of a security right in proceeds under the independent undertaking.

211. If the applicable law is not specified in the independent undertaking of the guarantor/issuer, confirmer or nominated person, the law governing the matters referred to in recommendation 210 is the law of the State of the location of the branch or office of the guarantor/issuer, confirmer or nominated person indicated in the independent undertaking. However, in the case of a nominated person that has not issued an independent undertaking, the applicable law is the law of the State of the location of the nominated person's branch or office that has or may pay or otherwise give value under the independent undertaking.

212. The law should provide that, if a security right in proceeds under an independent undertaking is created and is made effective against third parties automatically as a result of the effectiveness against third parties of a security right in a receivable, negotiable instrument or other obligation, the payment or other performance of which the independent undertaking secures, the creation and the effectiveness against third parties of the security right in the proceeds under the independent undertaking is governed by the law of the State whose law governs the creation and the effectiveness against third parties of the security right in the secured receivable, negotiable instrument or other obligation.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that recommendations 210 and 211 follow the conflict-of-laws rules applicable with respect to the rights and obligations of guarantor/issuers, confirmers or nominated persons. The only exception to the principle embodied in recommendations 210 and 211 is the rule in recommendation 212, for the limited issues of creation and third-party effectiveness in cases where a security right arises or is made effective against third parties automatically.]

⁶⁵ For recommendations 210-212, see A/CN.9/611/Add.1, recommendations 138 and 138 bis.

In addition, the commentary will explain that each bank (or sometimes non-bank) performing one of these roles acts pursuant to the law where it is located, meaning where its relevant branch or office is located (or the law it chooses, which is typically the law of the State where its relevant branch or office is located). Accordingly, different laws govern the different banks involved, and a choice of law in an independent undertaking governs only the particular issuer's obligations (see Uniform Rules for Demand Guarantees article 27, Uniform Commercial Code 5-116(b), and United Nations Assignment Convention article 29). The commentary will also explain that what recommendation 211 strives to do is be clear that a request for acknowledgement or for payment (without prior acknowledgement) made by a secured creditor (or the beneficiary on its behalf) is to be handled by the affected bank branch under its local law.

Under recommendations 210 and 211, all priority conflicts are subject to the law chosen by a guarantor/issuer, confirmer or nominated person or, in the absence of a choice of law, to the law of the relevant branch or office. The Working Group may wish to consider the question whether: (a) if a bank branch pays (or gives value to) a secured creditor, then that same law should apply to that secured creditor's priority contest with third parties; and (b) if the payment is to the beneficiary and the priority contest is among third parties, recommendations 210 and 211 should be inapplicable and residual conflict-of-laws rules apply (i.e. recommendation 197).

The commentary will further explain that: (a) creation of the security right is governed by the general conflict-of-laws rule in recommendation 197 for security rights in intangibles (except as provided in recommendation 212 for automatic creation); and (b) enforcement of the security right is governed by the general conflict-of-laws rule in recommendation 200, except to the extent otherwise provided in recommendations 210 and 211.]

Law applicable to the rights and obligations of third-party obligors and secured creditors⁶⁶

213. The law should provide that the following matters are governed by the law of the State whose law governs a receivable, negotiable instrument or negotiable document:

(a) The relationship between the debtor of the receivable and the assignee of the receivable, between an obligor under a negotiable instrument and the holder of a security right in the instrument or between the issuer of a negotiable document and the holder of a security right in the document;

(b) The conditions under which the assignment of the receivable, a security right in the negotiable instrument or in the negotiable document may be invoked against the debtor of the receivable, the obligor on the negotiable instrument or the issuer of the negotiable document; and

(c) The determination of whether the obligations of the debtor of the receivable, the obligor on the negotiable instrument or the issuer of the negotiable document have been discharged.

⁶⁶ See A/CN.9/611, recommendation 147.

C. Special rules when the applicable law is the law of a multi-unit State

[Note to the Working Group: The Working Group may wish to note that recommendations 214-217 are intended to provide ex ante certainty as to the application of the recommendations not only by a multi-unit State but also, most importantly, by a unitary State when the law applicable is the law of a multi-unit State. If the Working Group considers that these recommendations are too detailed for a guide, it may wish to consider whether these matters should be addressed with more general recommendations and appropriate explanations in the commentary.]

214. The law should provide that in applying the recommendations in this chapter to situations in which the State whose law governs an issue is a multi-unit State:

(a) Subject to subparagraph (b) of this recommendation, references to the law of a multi-unit State are to the law of the relevant territorial unit (as determined on the basis of the location of the grantor or of an encumbered asset or otherwise under the recommendations in this chapter) and, to the extent applicable in that unit, to the law of the multi-unit State itself;

(b) If the law in force in a territorial unit of a multi-unit State designates the law of another territorial unit of that State to govern third-party effectiveness or priority, the law of that other territorial unit governs that issue.

215. The law should provide that if, under the recommendations in this chapter, the applicable law is that of a multi-unit State or one of its territorial units, the internal choice of law rules in force in that multi-unit State shall determine whether the substantive rules of law of that multi-unit State or of a particular territorial unit of that multi-unit State shall apply.

[Note to the Working Group: The Working Group may wish to note that recommendations 214 and 215 track the language of article 12, paragraphs 2 and 3, of the Hague Securities Convention respectively. The Working Group may wish to consider a definition of “multi-unit State” along the lines of article 1, paragraph (1) (m) of that Convention (“multi-unit State” means a State within which two or more territorial units of that State, or both the State and one or more of its territorial units, have their own rules of law in respect of any of the issues specified in the recommendations in the Guide).]

216. The law should provide that, if the account holder and the depositary bank have agreed on the law of a specified territorial unit of a multi-unit State:

(a) The references to “State” in the first sentence of recommendation 208 (alternative A) are to that territorial unit;

(b) The references to “that State” in the second sentence of recommendation 208 (alternative A) are to the multi-unit State itself.

217. The law should provide that the law of a territorial unit applies if:

(a) Under recommendation 208 (alternative A) and 216, the designated law is that of a territorial unit of a multi-unit State;

(b) Under the law of that State the law of a territorial unit applies only if the depositary bank has an office within that territorial unit which satisfies the condition specified in the second sentence of recommendation 208 (alternative A); and

(c) The rule described in subparagraph (b) of this recommendation is in force at the time the security right in the bank account is created.

[Note to the Working Group: Recommendations 216 and 217, which track the language of article 12, paragraphs 1 and 4, of the Hague Securities Convention respectively, may be necessary if the Working Group decides to retain alternative A in recommendation 208.]

XIV. Transition⁶⁷

Purpose

The purpose of transition provisions of the law is to provide a fair and efficient transition from the regime before the enactment of the law to the regime after the enactment of the law.

Effective date

218. The law should specify either a date subsequent to its enactment, as of which it will enter into force (the “effective date”) or a mechanism by which the effective date may be specified.

[Note to the Working Group: The Working Group may wish to note that the commentary will clarify that, in determining the effective date, the State should take into account:

(a) The impact of the effective date on credit transactions and in particular the maximization of benefits to be derived from the law;

(b) The necessary regulatory, institutional, educational and other arrangements or infrastructure improvements to be made by the State; the status of the pre-existing law and other infrastructure;

(c) The harmonization of the law with other legislation;

(d) The content of constitutional rules with respect to pre-effective date transactions; and standard or convenient practice for the entry into force of legislation (e.g. on the first day of a month); and

(e) The need to give affected persons sufficient time to prepare for the law.]

Inapplicability of the law to disputes in litigation

219. The law should provide that:

(a) It does not apply to the rights and obligations of the parties to a security agreement if, at the effective date, they are the subject of litigation (or a comparable dispute resolution system); and

(b) It does not affect enforcement of a security right to the extent the secured creditor has taken steps towards enforcing it.

⁶⁷ See A/CN.9/WG.VI/WP.26/Add.8.

Transition period

220. The law should provide a period of time after the effective date (the “transition period”), during which:

(a) A security right created under the law in effect immediately before the effective date continues to exist under this law;

(b) A security right made effective against third parties under the law in effect immediately before the effective date remains effective against third parties under this law.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that the “law in effect immediately before the effective date” is the law of the State whose law governed an issue under the conflict-of-laws rules of the previous regime.]

Creation and third-party effectiveness of a security right

221. The law should provide that the existence of a security right created under the law in effect immediately before the effective date is determined by that law.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that the main rule is that, while creation of a security right before the effective date of the new law is determined by the old law, third-party effectiveness and priority are in principle determined by the new law. The commentary will also explain that recommendations 222-224 are intended to preserve third-party effectiveness under the old law and to give some time to parties to achieve third-party effectiveness under the new law. Moreover the commentary will explain that recommendation 226 is designed to set out one exception to the rule on which law determines priority by providing that the old law applies if all competing rights were created and made effective against third parties under the old law and no change occurred since the effective date of the new law.]

222. The law should provide that a security right made effective against third parties under the law in effect immediately before the effective date remains effective against third parties during the transition period. If, during the transition period or such longer period described in recommendation 223, the secured creditor takes any steps necessary to ensure that the security right is made effective against third parties under this law, its existence and effectiveness against third parties is continuous.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that, in cases in which the steps taken under the rules of the previous legal regimes also satisfy the requirements for third-party effectiveness under the new law, no additional steps need be taken. However, the commentary will also explain that a registration of a notice of a security right in a registry of a State other than the enacting State or in a different registry of the enacting State than provided in this law does not satisfy the requirements of this law; in such cases, recommendation 223 provides the applicable transition rule.]

223. The law should provide that a security right created and made effective against third parties by registration of a notice under the law in effect immediately before the effective date remains effective against third parties until the earlier of:

- (a) The date the registration would cease to be effective under that other law; and
- (b) [...] years after the effective date.

224. The law should provide that [, for purposes of applying its priority rules to a security right that was effective against third parties under the law in effect immediately before the effective date and is continuously effective against third parties under this law,] the date on which the security right was made effective against third parties or became the subject of a registered notice, as applicable, is the date on which such security right was made effective against third parties or became the subject of a registered notice under the law in effect immediately before the effective date.

Priority of a security right

225. Subject to recommendation 227, the law should provide that the priority of a security right as against the right of a competing claimant is governed by this law.

226. The law should provide that the priority of a security right as against the right of a competing claimant is determined by the law in effect immediately before the effective date if:

- (a) Both the security right and the right of the competing claimant are created before the effective date; and
- (b) The status of neither right has changed since the effective date.

227. The status of a security right has changed if:

- (a) It was effective against third parties on the effective date in accordance with recommendation 222 and later ceased to be effective against third parties; or
- (b) It was not effective against third parties on the effective date and later became effective against third parties.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that the law should ensure that the transition should not entail any cost other than the nominal cost of registration of a notice of a security right.]

**C. Report of the Working Group on Security Interests on the work of its
twelfth session (New York, 12-16 February 2007)
(A/CN.9/620) [Original: English]**

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I. Introduction

1. At its twelfth session, Working Group VI (Security Interests) continued its work on the preparation of a legislative guide on secured transactions pursuant to a decision taken by the Commission on International Trade Law (UNCITRAL) at its thirty-fourth session, in 2001.¹ The Commission's decision to undertake work in the area of secured credit law was taken in response to the need for an efficient legal regime that would remove legal obstacles to secured credit and could thus have a beneficial impact on the availability and the cost of credit.²

II. Organization of the session

2. The Working Group, which was composed of all States members of the Commission, held its twelfth session in New York from 12 to 16 February 2007. The session was attended by representatives of the following States members of the

¹ *Official Records of the General Assembly, Fifty-sixth Session, Supplement No. 17 and corrigendum (A/56/17 and Corr.3)*, para. 358. For a history of the project, see A/CN.9/WG.VI/WP.31. The reports of the first to the eleventh sessions of the Working Group are contained in documents A/CN.9/512, A/CN.9/531, A/CN.9/532, A/CN.9/543, A/CN.9/549, A/CN.9/570, A/CN.9/574, A/CN.9/588, A/CN.9/593, A/CN.9/603 and A/CN.9/617. The reports of the first and the second joint sessions of Working Group V (Insolvency Law) and VI (Security Interests) are contained in documents A/CN.9/535 and A/CN.9/550. The consideration of those reports by the Commission is reflected in the Official Records of the General Assembly, Fifty-seventh Session, Supplement No. 17 (A/57/17), paras. 202-204, Fifty-eighth Session, Supplement No. 17 (A/58/17), paras. 217-222, Fifty-ninth Session, Supplement No. 17 (A/59/17), paras. 75-78, Sixtieth Session, Supplement No. 17 (A/60/17), paras. 186-187, and Sixty-first Session, Supplement No. 17 (A/61/17), paras. 13-78.

² *Ibid.*, *Fifty-fifth Session, Supplement No. 17 (A/55/17)*, para. 455, and *Fifty-sixth Session, Supplement No. 17 and corrigendum (A/56/17 and Corr.3)*, para. 347.

Working Group: Argentina, Australia, Austria, Belgium, Benin, Cameroon, Canada, Chile, China, France, Gabon, Germany, Guatemala, India, Iran (Islamic Republic of), Italy, Japan, Kenya, Lebanon, Mexico, Morocco, Nigeria, Pakistan, Paraguay, Poland, Republic of Korea, Russian Federation, South Africa, Spain, Sweden, Switzerland, Thailand, Turkey, Uganda, United Kingdom of Great Britain and Northern Ireland, United States of America and Venezuela (Bolivarian Republic of).

3. The session was attended by observers from the following States: Democratic Republic of the Congo, Egypt, Hungary, Ireland, Malaysia, Mauritius, Philippines, Tonga and Yemen.

4. The session was also attended by observers from the following international organizations:

(a) *United Nations system*: International Monetary Fund, World Bank and World Intellectual Property Organization;

(b) *International Organizations*: Asian-African Legal Consultative Organization, Council of The Inter-Parliamentary Assembly of Member Nations of the Commonwealth of Independent States and European Community;

(c) *International non-governmental organizations invited by the Commission*: American Bar Association, Center for International Legal Studies, Commercial Finance Association, Forum for International Commercial Arbitration, International Bar Association, International Chamber of Commerce, International Insolvency Institute, International Trademark Association, Max-Planck Institute for Foreign and Private International Law, National Law Center for Inter-American Free Trade, New York City Bar Association and Union internationale des avocats.

5. The Working Group elected the following officers:

Chairman: Ms. Kathryn SABO (Canada)

Rapporteur: Ms. Maria del Pilar BONILLA DE ROBLES (Guatemala)

6. The Working Group had before it the following documents: A/CN.9/WG.VI/WP.29 (Revised recommendations); and A/CN.9/WG.VI/WP.31 and Addendum 1 (Revised commentaries).

7. The Working Group adopted the following agenda:

1. Opening of the session and scheduling of meetings.
2. Election of officers.
3. Adoption of the agenda.
4. Preparation of legislative guide on secured transactions.
5. Other business.
6. Adoption of the report.

III. Deliberations and decisions

8. The Working Group considered the recommendations contained in chapters III (Basic approaches to security and other general rules), IV (Creation of a security right (effectiveness as between the parties)), VIII (Rights and obligations of the

parties), IX (Rights and obligations of third-party obligors), XIII (Conflict of laws), XIV (Transition) (see A/CN.9/WG.VI/WP.29), as well as revised recommendations contained in chapter XII (Acquisition financing devices) based on a proposal by the Secretariat. The Working Group also considered the terminology and rules of interpretation of the draft Guide (see A/CN.9/WG.VI/WP.31/Add.1), as well as issues relating to security rights in directly held securities, financial contracts and intellectual property, based on proposals by the Secretariat. The deliberations and decisions of the Working Group are set out below in chapter IV. The Secretariat was requested to revise the recommendations in those chapters, as well as the terminology and rules of interpretation, to reflect the deliberations and decisions of the Working Group.

IV. Preparation of a legislative guide on secured transactions

Chapter III. Basic approaches to security and other general rules

Recommendation 8 (integrated and functional approach)

9. While some doubt was expressed as to whether retention-of-title sales and financial leases should be treated as security devices, broad support was expressed for an integrated and functional approach that would result in the secured transactions law covering all devices serving security functions. It was also agreed that the bracketed text in recommendation 8 should be revised to ensure that the law would apply to all devices that served security functions, while stating the conditions under which that result would be achieved if a State adopted a non-unitary approach to acquisition financing. Subject to that change, the Working Group approved the substance of recommendation 8.

Recommendation 9 (party autonomy)

10. The Working Group approved the substance of recommendation 9 unchanged.

Recommendations 10 and 11 (electronic communications)

11. There was broad support for recommendations 10 and 11 that expressed the principle of functional equivalence of paper to electronic writing and signature reflected in article 9 (2) and (3) of the United Nations Convention on the Use of Electronic Communications in International Contracts. On the understanding that the meaning of writing for the purposes of the creation of a security agreement was a matter addressed in recommendation 13, the Working Group approved the substance of recommendations 10 and 11 unchanged.

12. Noting that a signed writing was required for the security agreement (recommendation 13) and for the agreement of the debtor of a receivable not to raise any defences or rights of set off against the assignee (see recommendation 116, subparagraph (c)), the Working Group decided to defer discussion of recommendation 11 until it had an opportunity to discuss recommendation 13 (see para. 16).

Chapter IV. Creation of a security right (effectiveness as between the parties)

A. General recommendations

Recommendations 12 and 13 (creation of a security right)

13. It was agreed that recommendation 12 should be revised to address all the requirements for the effective creation of a security right (i.e. the agreement should reflect the intent of the parties to create a security right, the grantor should have a proprietary right in the asset or the power to dispose of the asset and the agreement should reasonably identify the encumbered asset and the secured obligation).

14. With regard to recommendation 13, it was agreed that the second bracketed text (referring to evidence of the grantor's intent to grant a security right) should be retained. It was also agreed that the reference to signature should be deleted, as it raised a question as to the types of acts that would qualify as "signature" and unnecessarily created another formal requirement for the creation of a security right. To avoid an implication that both the offer and the acceptance ought to be in writing in the case of a non-possessory security right, the Working Group agreed that the second sentence of recommendation 13 should be revised to refer to the agreement "being evidenced by a writing" rather than the agreement "being in writing".

15. Subject to those changes, the Working Group approved the substance of recommendations 12 and 13.

16. After completing its discussion of recommendations 12 and 13, the Working Group went back to recommendation 11 (see para. 12). It was agreed that, while a signed writing was required only for the waiver of defences by the debtor of a receivable, recommendation 11 should be retained. It was broadly felt that recommendation 11 stated an appropriate principle in the appropriate context of general rules. After discussion, the Working Group approved the substance of recommendation 11 unchanged.

Recommendations 15 (obligations subject to a security agreement) and 16-17 (assets subject to a security agreement)

17. The Working Group approved the substance of recommendation 15 unchanged. As to recommendation 16, it was agreed that any changes necessary to ensure that, with the exception of recommendations 23 and 24, the draft Guide did not override statutory prohibitions with respect to the transferability of assets could be discussed later in the session (see para. 117). After discussion, the Working Group approved the substance of recommendation 17 unchanged.

Recommendations 18 and 19 (creation of a security right in proceeds)

18. Noting that the definition of "proceeds" (see A/CN.9/WG.VI/WP.31/Add.1, definition (kk)) included the "civil and natural fruits" of encumbered assets and that the parties to a security agreement could always agree that a security right would not extend to proceeds or some types of proceeds, the Working Group approved the substance of recommendation 18 unchanged.

19. Differing views were expressed as to whether recommendation 19 should be retained. One view was that, while a security right should automatically extend to assets taking the place of encumbered assets, it should not cover additional assets, such as civil and natural fruits of encumbered assets, unless otherwise agreed by the parties. However, the prevailing view was that a security right should automatically extend even to civil and natural fruits as that result would reflect the normal expectations of the parties. It was stated that a different approach would create unnecessary cost and a trap for unwary parties. After discussion, the Working Group decided to delete recommendation 19. It was also agreed that the commentary should discuss the approach suggested in recommendation 19.

Recommendations 20 and 21 (commingled proceeds)

20. It was agreed that, as recommendation 20 dealt with tracing of commingled assets, it was equally applicable to the tracing of commingled goods (i.e. a mass or product) and should thus include a cross-reference to recommendation 29 (creation of a security right in a mass or product). Subject to that change, the Working Group approved the substance of recommendation 20. After discussion, the Working Group also approved the substance of recommendation 21 unchanged.

B. Asset-specific recommendations

Recommendation 22 (effectiveness of a bulk assignment and an assignment of future, parts of and undivided interests in receivables)

21. It was agreed that the word “contractual”, contained in recommendation 22 within square brackets, should be retained without square brackets in order to limit the application of recommendation 22 to contractual receivables (as in the United Nations Convention on the Assignment of Receivables in International Trade; the “United Nations Assignment Convention”) and thus avoid interfering with statutory restrictions on the transferability of non-contractual receivables. Subject to that change, the Working Group approved the substance of recommendation 22.

Recommendations 23 (effectiveness of an assignment made despite an anti-assignment clause), 24 (creation of a security right in a right that secures a receivable, a negotiable instrument or any other obligation) and 25 (creation of a security right in a right to payment of funds credited to a bank account)

22. After discussion, the Working Group approved the substance of recommendations 22 to 25 unchanged.

Recommendation 26 (creation of a security right in proceeds under an independent undertaking)

23. It was agreed that the last sentence of recommendation 26, which appeared within square brackets, should be deleted. It was stated that the point that the transferability of the right to draw under an independent undertaking was a matter for the law and practice of independent undertakings could usefully be clarified in the commentary. Subject to that change, the Working Group approved the substance of recommendation 26.

Recommendations 27 (creation of a security right in a negotiable document), 28 (creation of a security right in attachments) and 29 (creation of a security right in a mass or product)

24. After discussion, the Working Group approved the substance of recommendations 27 to 29 unchanged.

Chapter VIII. Rights and obligations of the parties

A. General recommendations

Recommendations 106 (suppletive rules relating to the rights of the secured creditor) and 107 (mandatory rules relating to the obligations of the party in possession)

25. After discussion, the Working Group approved the substance of recommendations 106 and 107 unchanged. It was also agreed that the commentary should discuss the application of the principle of party autonomy with respect to the rights and obligations of the parties to the security agreement. In addition, it was agreed that the rights and obligations of parties to acquisition financing transactions in the context of a non-unitary approach could be discussed later in the session (see para. 130).

B. Asset-specific recommendations

Recommendations 108 (rights and obligations of the assignor and the assignee), 109 (representations of the assignor), 110 (right to notify the debtor of the receivable) and 111 (right to payment)

26. After discussion, the Working Group approved the substance of recommendation 108 unchanged. With respect to recommendation 109, it was agreed that the text in square brackets, limiting the application of recommendation 109 to contractual receivables, should be retained outside square brackets. Subject to that change, the Working Group approved the substance of recommendation 109. After discussion, the Working Group also approved the substance of recommendations 110 and 111 unchanged.

Chapter IX. Rights and obligations of third-party obligors

A. Rights and obligations of the debtor of the receivable

Recommendations 112 (protection of the debtor of the receivable), 113 (notification of the debtor of the receivable), 114 (discharge of the debtor of the receivable by payment), 115 (defences and rights of set-off of the debtor of the receivable), 116 (agreement not to raise defences or rights of set-off), 117 (modification of the original contract) and 118 (recovery of payments)

27. Noting that recommendations 112 to 118 reflected the principles embodied in articles 15 to 21 of the United Nations Assignment Convention, the Working Group approved their substance unchanged.

B. Rights and obligations of the obligor under a negotiable instrument**Recommendation 119**

28. After discussion, the Working Group approved the substance of recommendation 119 unchanged.

C. Rights and obligations of the depositary bank**Recommendations 120 and 121**

29. After discussion, the Working Group approved the substance of recommendations 120 and 121 unchanged.

D. Rights and obligations of the guarantor/issuer, confirmer or nominated person of an independent undertaking**Recommendations 122-124**

30. It was agreed that subparagraph (b) of recommendation 122 should refer to the rights of a transferee not being affected by a security right in proceeds under an independent undertaking created by the transferor, irrespective of the time of creation of the security right. Subject to that change, the Working Group approved the substance of recommendation 122. After discussion, the Working Group also approved the substance of recommendations 123 and 124 unchanged.

E. Rights and obligations of the issuer of a negotiable document**Recommendation 125**

31. After discussion, the Working Group approved the substance of recommendation 125 unchanged.

Chapter XIII. Conflict of laws**A. General recommendations****Recommendation 195 (law applicable to a security right in tangible property)**

32. It was generally agreed that the creation, third-party effectiveness and priority of a security right in tangible property should be subject to the law of State in which the property was located (*lex rei sitae*). It was also widely felt that that approach would result in uncertainty as to the law applicable to tangible property of a type ordinarily used in more than one State and thus security rights in such property should be subject to the law of the State in which the grantor was located. It was also generally thought that, while ships and aircraft would always fit into the category of mobile property, motor vehicles might not fit, at least in the case of island States in which motor vehicles would very rarely cross national borders.

33. As to the provision in the third sentence of recommendation 195 with respect to tangible property that was subject to title registration, while it was agreed that a recommendation along those lines would be useful, its current formulation raised a number of concerns. One concern was that the recommendation did not make clear which law applied to the question of whether title registration was required. Another concern was that, in the case of assets subject to multiple registrations, the recommendation might inadvertently result in the application of multiple laws.

34. Deferring that issue to a later time in the session (see para. 121), the Working Group approved the substance of the remainder of recommendation 195 unchanged.

Recommendation 196 (law applicable to a security right in goods in transit and export goods)

35. There was broad support for recommendation 196, which allowed a secured creditor with a security right in goods in transit or export goods to create and make effective against third parties its security right under the law of the ultimate destination of the goods (exclusively or in addition to the requirements of the law of the initial location of the goods under recommendation 195), provided that the goods reached that destination within a reasonable period of time. In response to a question, it was noted that priority would still be subject, under recommendations 195 and 203, to the law of the State in which the goods would be located at the time a priority dispute arose. It was also stated that the length of a reasonable period of time would depend on factors, such as the distance of the journey and the means of transport.

36. The concern was expressed, however, that, in the case of goods covered by a negotiable document, recommendation 196 might not provide a clear rule in situations where the document was located in one State and the goods were located in another State. In order to address that concern, the suggestion was made that the scope of recommendation 196 should be expanded to cover negotiable documents moving with the goods they covered. That suggestion was objected to. It was stated that recommendation 196 would in any case apply irrespective of whether the goods were accompanied by a negotiable document or not. It was also observed that recommendation 195 was sufficient to provide that the law applicable to a security right in a document of title would be the law of the location of the document. In addition, it was said that the reliability of documents of title would be enhanced since, if the State whose law was applicable were a State that had enacted the recommendations of the draft Guide, possession of the document would give a superior right with respect to goods covered by a negotiable document.

37. After discussion, the Working Group approved the substance of recommendation 196 unchanged.

Recommendation 197 (law applicable to a security right in intangible property)

38. Broad support was expressed for recommendation 197, which provided that the creation, third-party effectiveness and priority of a security right in intangible property should be subject to the law of the State in which the grantor was located. It was noted that recommendation 197 appropriately reflected the approach of articles 22 and 30 of the United Nations Assignment Convention.

39. However, some doubt was expressed as to whether the law of the grantor's location was appropriate for security rights in financial assets (such as derivatives or repurchase agreements), directly held securities and rights to payment of funds credited to a bank account. With respect to security rights in rights to payment of funds credited to a bank account, it was agreed that reference should be made to recommendation 208, which provided for the application of a law that might be other than the law of the grantor's location. As to directly held securities and financial contracts, the Working Group deferred discussion to a later time in the session (see paras. 99-110).

40. With respect to the text that appeared in square brackets in recommendation 197, it was agreed that it mainly raised the question of the law applicable to security rights in intellectual property. It was widely felt that, as the matter raised complex questions on which diverging views were expressed, the bracketed text should be deleted and the matter referred to future work (see para. 122).

41. Subject to those changes, the Working Group approved the substance of recommendation 197.

Recommendation 198 (law applicable to a security right in proceeds)

42. After discussion, the Working Group approved the substance of recommendation 198 unchanged.

Recommendation 199 (law applicable to the rights and obligations of the grantor and the secured creditor)

43. While broad support was expressed for recommendation 199, some doubt was expressed as to the appropriateness of referring the mutual rights and obligations of the parties to a law other than the law governing the creation of a security right. It was observed that a proposed regulation under preparation by the European Commission might take a different approach. In response, it was noted that recommendation 199 reflected a well-thought approach taken in article 28 of the United Nations Assignment Convention. It was also noted that the approach taken in recommendation 199 should be taken into account so as to achieve universally uniform conflict-of-laws rules that would greatly benefit parties to such financing transactions all over the world. In any case, it was noted that regional legislation could be referred to in the draft Guide for the benefit of States from the relevant region, but could not dictate international legislation, unless it was of interest to and attracted the support of the international community as a whole.

44. After discussion, the Working Group approved the substance of recommendation 199 unchanged.

Recommendations 200 and 201 (law applicable to the enforcement of a security right)

45. Differing views were expressed with regard to the law applicable to the enforcement of a security right. One view was that enforcement should be subject to the law governing the security agreement, with the specific exception of out-of-court repossession of encumbered assets by the secured creditor without the consent of the grantor, which should be subject to the law of the State in which the relevant assets were located (alternative B). It was stated that such an approach would result

in one law governing enforcement even where various enforcement actions took place in different States or related to out-of-court enforcement. It was also observed that, in particular with respect to intangible assets, that approach would be appropriate, as the location of intangible assets could not be easily determined and, in any case, could involve multiple jurisdictions.

46. However, the prevailing view was that enforcement of a security right should be subject to the law of the State in which enforcement took place (alternative A). It was stated that enforcement related to procedural matters or, in any case, matters of public policy, and thus could be subject only to the law of the place in which it took place. It was also stated that, in a priority contest with respect to the proceeds of enforcement between two secured creditors, alternative A would result in the application of a single law, while alternative B could result in the application of different laws. In addition, it was stated that the rule could not be structured on the basis of a distinction between judicial and extra-judicial enforcement as the type of enforcement involved in each case could not be predicted by the parties at the time of the conclusion of the financing transaction or even later before default.

47. While it was agreed that alternative A should be retained with respect to the enforcement of a security right in tangible assets, it was stated that, in the case of intangible assets, an approach based on the place of enforcement could lead to the application of multiple laws as different enforcement steps (e.g. notification, collection or sale) could take place in different States.

48. After discussion, it was agreed that a different rule should be prepared with respect to the enforcement of a security right in intangible assets based on the law applicable to the creation, third-party effectiveness and priority of a security right in intangible property.

49. Further to the deletion of alternative B in recommendation 200, which referred enforcement of a security right to the law governing the security agreement, the Working Group agreed that recommendation 201 should also be deleted, as, under revised recommendation 200, enforcement of a security right in an attachment to immovable property would always take place in the State in which the immovable property was located and be subject to the law of that State.

Applicable law in insolvency proceedings

50. It was agreed that, to ensure greater consistency between recommendation 171 and recommendations 30 and 31 of the UNCITRAL Legislative Guide on Insolvency Law, recommendation 171 might need to be revised. It was widely felt that the aim of recommendation 171 was to provide that the law applicable to creation, effectiveness against third parties, priority and enforcement of a security right was the law applicable in the absence of insolvency proceedings, except to the extent otherwise provided by the relevant insolvency law. Subject to that change, the Working Group approved the substance of recommendation 171.

Recommendations 202 (meaning of “location” of the grantor), 203 (relevant time when determining location), 204 (continued third-party effectiveness of a security right upon change of location), 205 (exclusion of *renvoi*) and 206 (public policy and internationally mandatory rules)

51. After discussion, the Working Group adopted the substance of recommendations 202 to 204 and 206 unchanged.

52. With regard to recommendation 204, the concern was expressed that, by requiring registration in the new jurisdiction to which the assets or the grantor might move, it might add to the cost of financing transactions. It was stated that, not only costs for double registration, namely in the country of the exporter and in the country of the importer, but also considerable costs for legal support in a foreign country in order to fulfil the requirements for registration, would be incurred. In response, it was observed that recommendation 204 reflected the approach taken under current law outside the draft Guide. It was also stated that recommendation 204 introduced a positive new element of preserving for some time after the change of location of the assets or the grantor the third-party effectiveness of a security right created and made effective against third parties under the law of another jurisdiction. In addition, it was said that recommendation 196 provided an exporter the possibility of ensuring third-party effectiveness of its security right exclusively in the country to which the relevant goods would be imported. Moreover, it was pointed out that further improvements could be left to practice. In that connection, reference was made to jurisdictions allowing national or even international registration, as well as to jurisdictions in which service providers handled multi-jurisdictional registrations at relatively low cost.

53. With regard to recommendation 205, it was agreed that a cross-reference should be included to recommendations 214 and 215, which allowed *renvoi* in the case the applicable law was the law of a multi-unit State. Subject to that change, the Working Group approved the substance of recommendation 205.

B. Asset-specific recommendations

Recommendation 207 (law applicable to receivables arising from a sale, lease or security agreement relating to immovable property)

54. After discussion, the Working Group approved the substance of recommendation 207 unchanged.

Recommendation 208 (law applicable to a security right in a right to payment of funds credited to a bank account)

55. Differing views were expressed as to the law applicable to the creation, third-party effectiveness, priority and enforcement of a security right in rights to payment of funds credited to a bank account, as well as the rights and duties of the depositary bank with respect to that security right. One view was that those matters should be subject to the law governing the bank account agreement or other law provided in the account agreement, under the condition that the bank had a branch in the State whose law would be applicable (alternative A). It was stated that that approach

provided certainty and was practical as the location of a bank account could not be determined.

56. However, the predominant view was that those matters should be referred to the law of the State in which the bank that maintained the account had its place of business or, in the case of more than one place of business, to the law of the State in which the branch maintaining the account was located. It was stated that that approach provided certainty and transparency as to the law applicable. It was also observed that that approach reflected the normal expectations of the parties and provided for the application of one law to issues relating to banking activities.

57. After discussion, despite the predominant view in favour of alternative B and in view of the strongly held views in favour of alternative A, the Working Group decided to retain both alternatives A and B. It was widely felt, however, that further efforts should be undertaken to reach agreement on one recommendation, since, if both alternative recommendations were retained and implemented by States, a different law would apply depending on the State in which a dispute arose, a result that would preserve the uncertainty as to the law applicable to that matter (for the continuation of the discussion, see paras. 123-128).

Recommendation 209 (law applicable to the third-party effectiveness of a security right in specified types of asset by registration)

58. After discussion, the Working Group approved the substance of recommendation 209 unchanged.

Recommendations 210-212 (law applicable to a security right in proceeds under an independent undertaking)

59. It was stated that recommendation 211 might need to be revised, as a nominated person would typically confirm a credit but not issue an independent undertaking. After discussion, the Working Group approved the substance of recommendations 210 to 212 unchanged.

Recommendation 213 (law applicable to the rights and obligations of third-party obligors and secured creditors)

60. After discussion, the Working Group approved the substance of recommendation 213 unchanged.

C. Special rules when the applicable law is the law of a multi-unit State

Recommendations 214-217

61. Some doubt was expressed as to whether it was appropriate to allow *renvoi* (i.e. that reference to the law of a State included the conflict-of-laws rules of the State), in cases where the applicable law was the law of a multi-unit State. In response, it was stated that, as long as the law of the State whose law was applicable applied, no uncertainty as to the applicable law would arise. It was also observed that that approach was necessary in cases where a notice about a security right had to be registered in a registry located in one of the units of a multi-unit State. After

discussion, the Working Group approved the substance of recommendations 214 to 217 unchanged (see para. 129).

Chapter XIV. Transition

62. It was widely felt that transition rules were of crucial importance for the acceptability and implementation of a new secured transactions law. It was thus agreed that the commentary should discuss steps to be taken by States to ensure the effectiveness of existing security rights under the new law, the need for commentaries, registration and other similar forms referred to in the law, as well as of educational programs to assist judges, arbitrators, practitioners and the industry in understanding and applying the new law.

Recommendation 218 (effective date)

63. The Working Group approved the substance of recommendation 218 unchanged. It was widely felt that the determination of the effective date of the new law (i.e. the date as of which it would enter into force) was an important factor for the acceptability of the new law. It was also agreed that the commentary could discuss additional criteria for the determination of the length of the effective date, such as the need to educate practitioners and enable them to participate in the implementation of the law, as well as the time necessary for parties to register a notice in the registry established by the new law.

Recommendation 219 (inapplicability of the law to disputes in litigation)

64. It was agreed that the new law should not apply to the rights of any claimant involved in litigation or other dispute resolution mechanism with respect to one or more security rights (and not just the parties to a security agreement as provided in subparagraph (a) of recommendation 219). It was also agreed that the new law should leave unaffected not only the enforcement (as provided in subparagraph (b) of recommendation 219) but also the priority of a security right if the process towards its enforcement had been initiated before the effective date of the new law. Subject to those changes, the Working Group approved the substance of recommendation 219.

Recommendation 220 (transition period)

65. With respect to subparagraph (a) of recommendation 220, it was stated that it was unnecessary, as the issue of the existence under the new law of a security right created under the old law was sufficiently addressed by recommendation 221. It was also observed that recommendation 221 was more appropriate in that it provided that a right created under the old law would exist under the new law without any time limitation. As to subparagraph (b) of recommendation 220, it was pointed out that it was equally unnecessary, as the issue of the third-party effectiveness under the new law of a security right that had been made effective against third parties under the old law was sufficiently addressed by recommendation 222.

66. It was stated, however, that the definition of the term “transition period” should be retained perhaps in recommendation 222, while criteria for the determination of its length should be discussed in the commentary. In that

connection, it was stated that the principal criterion for the determination of the length of the transition period was the need to ensure that persons affected by the new law would be given the time necessary for them to become familiar with the new law and to take the action required to preserve their rights. It was also observed that, in some States, the loss of priority as a result of failure of a party to meet the requirements of third-party effectiveness under the new law might be treated as illegal deprivation of property, unless the transition period was found to be reasonable. It was also observed that the number of transactions with respect to which a notice would need to be registered in the new registry might also be taken into account in determining the length of the transition period.

67. After discussion, the Working Group decided that recommendation 220 should be deleted subject to the inclusion of the definition of the term “transition period” in recommendation 222. It was also agreed that the commentary should discuss criteria for determining the length of the transition period.

Recommendations 221-224 (creation and third-party effectiveness of a security right)

68. After discussion, the Working Group approved the substance of recommendations 221 to 223 unchanged. Subject to removing the brackets around the text in recommendation 224, the Working Group approved the substance of recommendation 224.

Recommendations 225-227 (priority of a security right)

69. After discussion, the Working Group approved the substance of recommendations 225 to 227 unchanged.

Chapter XII. Acquisition financing devices

General remarks

70. The Working Group considered a revised version of the recommendations on acquisition financing devices on the basis of a proposal by the Secretariat. It was noted that it was not possible for those recommendations to be made available well in advance of the present session of the Working Group, as they were prepared by the Secretariat to address the views expressed and the suggestions made during the eleventh session of the Working Group (Vienna, 4-8 December 2006). However, the view was expressed that final decision with respect to those recommendations would have to be postponed until the Commission session.

71. Differing views were expressed as to whether the presentation of the material in the chapter should remain as it was, with the unitary approach being followed by the non-unitary approach, or whether the unitary approach should be integrated into the other relevant chapters of the draft Guide, leaving the discussion of the non-unitary approach in a separate Chapter.

72. One view was that the discussion and the recommendations of the unitary approach should be integrated into the other relevant chapters. It was stated that in that way the unitary approach would be simpler and easier for legislators to

understand and implement. It was also observed that, in order to keep a parallel structure, the unitary approach was made more complicated than it actually was.

73. The prevailing view, however, was that the current parallel structure should be preserved. It was stated that such a presentation of the material would be of greater assistance to those States considering which approach to adopt or seeking to understand the changes that a law reform in the direction of the unitary approach would involve. It was also observed that having a chapter only on the non-unitary approach might result in that approach appearing as the only approach recommended in the draft Guide with respect to acquisition financing rights.

74. After discussion, the Working Group agreed that the current presentation of the material with a discussion of the unitary and the non-unitary approach to acquisition financing devices should be preserved.

75. It was also agreed that the commentary could usefully clarify that two alternative approaches were proposed with regard to acquisition financing devices and provide some guidance as to the consequences for the ownership of an asset subject to an acquisition financing device (e.g. consequences of failure to effect registration of a notice with respect to a retention-of-title sale).

Terminology

76. The Working Group approved the substance of the definitions of the terms “acquisition security right”, “acquisition secured creditor” and “acquisition financier” unchanged.

77. With regard to the definition of the term “acquisition financing right”, it was observed that, while it listed some typical acquisition financing transactions, it also included language that would cover any transaction in which title was used to finance the acquisition of a tangible asset. The example was given of sales with deferred transfer-of-title provisions that could be acquisition financing devices or not, depending on whether title was used to secure the payment of the price.

78. The Working Group agreed to include in the definition of the term “acquisition security right” an express reference to another common type of acquisition financing transaction, hire-purchase agreements. The Working Group also agreed to replace references to the terms “assets” or “goods” with the term “tangible property” to ensure that the recommendations on acquisition financing would apply only to tangible assets (see para. 113). Subject to those changes, the Working Group approved the substance of the definition of the term “acquisition financing right”.

79. In the discussion, the question was raised as to whether the definition of “acquisition financing right” would cover repurchase transactions (“repos”). It was noted that repos typically involved indirectly held securities and would thus fall outside the scope of the draft Guide (see recommendation 5). It was also noted, however, that repos of tangible assets would be covered by the definition of “security right” and, as a result, the recommendations of the draft Guide would apply to such repos.

80. The Working Group approved the substance of the definition of an “acquisition financing transferee”, noting that the commentary should provide guidance on the interpretation of the definition (e.g. that it covered a lessee although it was not a transferee).

81. With regard to the definition of the term “retention-of-title right”, it was suggested that it should be revised to reflect the understanding in several jurisdictions that retention of title involved a conditional transfer of title. There was support for that suggestion on the understanding that the definition of the term “acquisition financing right” would include language to ensure that other types of retention-of-title clauses were also covered.

82. After discussion, the Working Group approved the substance of the definition of the term “financial lease” unchanged, noting that it included language to cover hire-purchase agreements.

A. Unitary approach to acquisition financing devices

83. After discussion, the Working Group approved the substance of recommendations 181 to 197 unchanged.

B. Non-unitary approach to acquisition financing rights

84. An objection was raised with respect to the principle of functional equivalence of security rights and acquisition financing rights and in particular with respect to the registration of a notice about a retention-of-title sale or a financial lease. However, it was widely felt that that principle was one of the fundamental elements of a modern secured transactions regime and should be preserved. It was stated, in particular, that a modern notice-registration system that would apply to all devices serving security functions was a *conditio sine qua non* (a necessary condition) for an effective and efficient secured transactions regime.

85. The concern was expressed that the functional approach might inadvertently result in re-characterization of a title device to a security device. In response, it was stated that the re-characterization of certain title devices as security devices was common practice in most jurisdictions (in particular in the case of insolvency). It was also observed that, even in jurisdictions in which retention of title was the main acquisition-financing device, title was bifurcated to the extent that the seller retained ownership and the buyer acquired an expectation of ownership (i.e. a sufficient right to encumber the goods purchased). In addition, it was said that, in any case, that result did not affect fundamental notions of property or other law.

86. In response to a question as to the differences between the unitary and the non-unitary approach, it was stated that the main difference arose in the case of enforcement (within and outside insolvency). It was also observed that, in the context of a unitary approach, the principles applicable to the enforcement of any security right would apply equally to the enforcement of an acquisition security right. In addition, it was said that, in the context of a non-unitary approach, functional equivalence would be preserved to the extent compatible with the regime applicable to the enforcement of ownership rights.

87. While in view of that difference, some doubt was expressed as to whether a distinction between a unitary and a non-unitary approach was useful, strong support was expressed for preserving the non-unitary approach for States that would prefer to enact the recommendations of the draft Guide while relying on existing laws to

some extent and without having to undertake a major overhaul of their secured transactions regimes. It was stated that the non-unitary approach to acquisition financing devices constituted one of the major achievements of the draft Guide in promoting harmonization of the law of security interests.

88. The Working Group reiterated its approval of the functional approach and the distinction between unitary and non-unitary approach to acquisition financing devices. It was also agreed that a different set of recommendations should apply in the context of each approach and decided to delete a recommendation leading to the contrary result.

89. After discussion, the Working Group approved the substance of recommendations 181 bis-195 and 197 unchanged. With respect to the creation and third-party effectiveness of a security right in consumer goods, it was agreed that the commentary should clarify that the threshold of the written form requirement was low and related to an indication of the financier's intent to have an acquisition security right, and that no registration was required for security rights in consumer goods.

90. With respect to the enforcement of an acquisition financing right (recommendation 196), the Working Group approved a text along the following lines:

“The law should provide, with respect to post-default rights relating to an acquisition financing right, that:

(a) The same principles and objectives indicated in the Guide's recommendations with respect to post-default rights relating to security rights are applicable;

(b) Even if the rules effectuating those principles and objectives in the context of acquisition financing rights differ from those applicable to security rights, the rules should produce results that are the functional equivalent of results obtained in the context of security rights; and

(c) In seeking to provide for functionally equivalent results, the rules applicable to post-default enforcement of an acquisition financing right under a current regime be modified to the extent necessary to produce congruity with the security rights regime recommended by the Guide to the greatest extent possible without compromising the coherence of the ownership regime, and divergences from the rules applicable to security rights under the Guide be made only to the extent necessary to preserve the coherence of the ownership regime. Any divergences from the rules applicable to post-default rights relating to security rights under the Guide should not have the effect of limiting, overriding or otherwise affecting the application of the Guide's recommendations relating to creation, third-party effectiveness, registration and priority of acquisition financing rights.”

Terminology and rules of interpretation

91. Having completed its discussion of the recommendations of the draft Guide (see A/CN.9/WG.VI/WP.29), the Working Group considered terminology and rules

of interpretation (for the terminology and rules of interpretation, see A/CN.9/WG.VI/WP.31/Add.1).

92. The Working Group approved the substance of recommendations (a) to (z) unchanged. The Working Group also agreed that a definition of the term “money” should be added along the following lines: “‘Money’ means currency in use as a medium of exchange authorized by a Government.” It was noted that, under the draft Guide: money meant tangible money and not just a book entry, which could be a “receivable”; money in a bank account was “funds credited to a bank account”; a cheque was a “negotiable instrument”; and money held by a coin dealer as part of a collection was not “money”.

93. With respect to definition (aa) (“independent undertaking”), it was agreed that it should be revised to clarify that the list of types of independent undertaking in parenthesis was indicative and not exhaustive.

94. With respect to definition (bb) (“proceeds under an independent undertaking”), it was agreed that the commentary should explain that a draft accepted or obligation incurred could give rise to proceeds under an independent understanding only together with payment. In that connection, it was agreed that the term “honour” in the context of an independent undertaking, which meant a two-step process (i.e. acceptance of a draft or incurring an obligation and payment), could be usefully defined. It was also agreed that definition (bb) should be conformed to the terminology used in the latest version of the Uniform Customs and Practice for Documentary Credits (i.e. UCP 600).

95. Subject to those changes, the Working Group approved the substance of definitions (aa) and (bb).

96. After discussion, the Working Group approved the substance of definitions (cc)-(uu) and (yy) unchanged.

97. With respect to definitions (vv), (ww) and (xx) (“buyer in the ordinary course of business”, “lessee in the ordinary course of business” and “licensee in the ordinary course of business”), the Working Group confirmed its earlier decision that the thrust of those definitions would be moved to the appropriate recommendations (A/CN.9/617, para. 48) and agreed that the language in square brackets could be left out, while the definitions could be deleted.

98. In the discussion, the view was expressed that the definitions should be listed in alphabetical order in all language versions. That suggestion received support. Subject to the editorial rules of the United Nations, the Secretariat was requested to list the definitions in alphabetical order so as to make the terminology more user-friendly.

Security rights in directly held securities

99. Recalling its decision to address in the draft Guide directly held securities, i.e. securities held directly by their owner and not through an intermediary (see A/CN.9/WG.VI/WP.29, recommendation 5, and A/CN.9/617, para. 15), the Working Group noted that directly held securities might be represented by certificates, such as stock certificates or bonds (“certificated” securities) or reflected

as a book entry (“uncertificated” or “dematerialized” securities, which should not be confused with certificated securities held in a securities account through an intermediary).

100. It was also noted that: with respect to directly held certificated securities, the Working Group might wish to consider whether the recommendations should closely parallel the recommendations applicable to negotiable instruments; and with respect to directly held dematerialized securities, the Working Group might wish to consider whether the recommendations should closely parallel the recommendations applicable to rights to payment of funds credited to a bank account.

101. Differing views were expressed as to whether certain types of directly held securities should be covered in the draft Guide. One view was that the draft Guide should address certain types of directly held securities along the lines proposed above. It was stated that transactions relating to directly held securities, such as those in which a parent company obtained credit by offering as security shares of its wholly-owned subsidiaries, were extremely important in facilitating small- and medium-size- enterprises’ access to credit. It was also observed that failure to address such directly held securities in the draft Guide would leave a big gap in the draft Guide and inadvertently result in depriving many enterprises from access to credit. In that connection, it was noted that neither the Convention on the Law Applicable to Certain Rights in respect of Securities held with an Intermediary, prepared by the Hague Conference on Private International Law, nor the draft UNIDROIT Convention on harmonized substantive rules regarding securities held with an intermediary, currently being prepared by the International Institute for the Unification of Private Law (UNIDROIT), addressed securities that were not held through an intermediary.

102. Another view was that directly held securities should not be addressed in the draft Guide at all. It was stated that addressing directly held securities in the draft Guide would be extremely difficult as there was no universally acceptable definition of directly held securities. In addition, it was said that that addressing directly held securities in the draft Guide at the present time might create overlap and conflict with the draft Convention being prepared by UNIDROIT. Moreover, it was pointed out that conflict with the UNIDROIT draft Convention could arise, for example, because the UNIDROIT draft Convention treated title-transfer transactions as functionally equivalent but did not equate them fully to security rights. Moreover, it was pointed out that addressing directly held securities in the draft Guide might create overlap and conflict with European Union law. In that connection, it was mentioned that the re-characterization of title transactions as security transactions and the application of the law of the grantor’s location were matters of particular concern.

103. Yet another view was that addressing issues relating to directly held securities should be treated as a subject for future work. It was stated that it would be useful to address the taking of security in directly held securities but such work needed further careful study. It was also observed that deferring the matter to future work would allow States to take stock of the achievements of the UNIDROIT draft Convention and then decide whether further work could be undertaken. Matters that mentioned among those that required additional work included: definitions of the relevant terms; identification and exclusion of title-transfer arrangements, such as repurchase agreements, stock loans and other title-transfer collateral arrangements,

all of which could relate to directly or indirectly held securities; anti-assignment agreements; priority issues (e.g. control giving a right superior to registration); and applicable-law issues.

104. In an effort to reach agreement, several suggestions were made. One suggestion was to ensure that intermediated securities were excluded in a clear and unambiguous way. It was stated that most of the transactions mentioned as not fitting in the draft Guide related to intermediated securities. Another suggestion was to include transactions in which an individual investor or enterprise granted a security in shares held directly without the involvement of any intermediary to obtain credit. Yet another suggestion was to exclude financial contracts relating to securities. A further suggestion was to address directly held securities in the draft Guide, but only to the extent that its provisions were not inconsistent with national law or international agreements governing securities, while the Commission could be invited to consider future work on directly held securities. While interest was expressed in all those suggestions, it was widely felt that further work was necessary before a decision could be made.

105. An additional suggestion was to list in the draft Guide a limited number of specific transactions to be covered (in which securities held directly by their owner could be used as security for credit), while financial contracts relating to securities and any intermediated securities covered by Unidroit's work could be excluded. Examples of securities that would be covered included shares of a subsidiary held by a parent company and untraded shares of small- and medium-size companies.

106. While interest was expressed in proceeding on the basis of a concrete and limited list of transactions to be covered, it was widely felt that more work was necessary to define those transactions and to reach agreement as to how they should be covered. On the other hand, there was support for the idea that that suggestion, supplemented by the principles reflected above as to how to address the relevant issues in the draft Guide (see para. 100), provided a reasonable basis for further discussion. It was stated that a proposal along those lines could be prepared by interested States to assist the Commission in addressing the treatment of those transactions in the draft Guide.

107. After discussion, the Working Group agreed that the text that appeared in recommendation 5 within square brackets, limiting the exclusion to indirectly held securities, should be retained within square brackets. It was also agreed that the Commission might wish to consider whether certain defined and limited types of securities should be covered in the draft Guide or whether that matter should be addressed in the context of future work.

Security rights in financial contracts

108. Leaving aside securities-related transactions discussed above (e.g. repurchase agreements and stock-lending transactions), the Working Group focused on other financial contracts relating to netting agreements (e.g. derivatives). The suggestion was made that those transactions should be excluded from the scope of the draft Guide or, at least, of recommendation 197 (law applicable to security rights in intangible property). It was stated that the law of the State in which the grantor was located was not appropriate, as the debtor of the receivable would not be able to

know which law applied to priority issues. It was also stated that excluding such financial contracts at least from the scope of recommendation 197 would be consistent with the approach taken in the United Nations Assignment Convention (see articles 4, paragraph 2 (b), and 5, subparagraphs (k) and (l)), and would ensure that the draft Guide would not be inconsistent with other law.

109. The suggestion to exclude financial contracts relating to netting agreements from the scope of the draft Guide or just recommendation 197 (see para. 108) was objected to. It was stated that the basic approach taken in the draft Guide was that, with limited specific exceptions with respect to which the law was well developed and application of the draft Guide was not necessary or appropriate, all types of movable property, whether tangible or intangible, could be used as security for credit. It was also observed that, under the United Nations Assignment Convention, issues of priority and the law applicable to priority were separate from issues of debtor protection and the law applicable thereto, and did not concern the debtor of a receivable. In addition, it was said that the proposed exclusion of financial contracts would inadvertently result in the draft Guide failing to provide guidance to States on a number of important issues. Moreover, it was pointed out that the scope of the Convention as an international text and of the draft Guide as a text relating to national law had to be different. In that connection, it was mentioned that the Convention referred priority issues to domestic law and the Guide was designed to provide guidance precisely on the contents of domestic law.

110. After discussion, the Working Group confirmed its decision that, with the exception of a specific and limited number of assets, all types of movable property, whether tangible or intangible, including financial contracts, could be used as security for credit in accordance with the provisions recommended in the draft Guide.

Security rights in intellectual property

111. It was noted that, at its thirty-ninth session in 2006, the Commission had requested the Secretariat to prepare, in cooperation with other organizations and in particular the World Intellectual Property Organization, a note discussing future work by the Commission on security rights in intellectual property. It was also noted that, at that session, the Commission had also requested the Secretariat to organize a colloquium to obtain the views of governmental and non-governmental experts (A/61/17, paragraph 86).

112. The Working Group noted that that colloquium had taken place in Vienna on 18 and 19 January 2007, and that, while support had been expressed for work by the Commission, at the same time several concerns had been expressed with respect to the treatment of security rights in intellectual property in the draft Guide. It was also noted that some of those concerns could be addressed by clarifying the text of some definitions and recommendations without changing policy decisions made by the Working Group. In addition, it was noted that other concerns would be discussed in a note by the Secretariat on future work to be considered by the Commission at its upcoming fortieth session (Vienna, 25 June-12 July 2007).

Terminology

113. With regard to the definitions of the terms “acquisition security right”, “acquisition financing right”, “retention-of-title right” and “financial lease”, the Working Group agreed to refer explicitly to “tangible property”, so as to ensure that those definitions and the relevant recommendations applied only to tangible property and not to intellectual property, leaving the important issue of financing of the acquisition of intellectual property to future work (see para. 78).

114. It was also agreed to delete from the definition of the term “receivable” the reference to “the performance of non-monetary obligations”, so as to clarify that the definition and the recommendations relating to receivables applied only to receivables and not, for example, to the rights of a licensee or the obligations of a licensor under a contractual licence of intellectual property.

115. In addition, it was agreed that reference should be added to the definition of the term “intellectual property” to service marks, trade secrets and designs. It was also agreed that the commentary should refer to the main international agreements concerned, such as, for example, article 2 (viii) of the Convention Establishing the World Intellectual Property Organization and the Agreement on Trade-Related Aspects of Intellectual Property Rights (“TRIPS”).

Recommendation 4 (aircraft, railway rolling stock, space objects, ships and intellectual property)

116. The Working Group noted that the draft Guide would not apply to intellectual property to the extent of any inconsistency between the secured transactions law and national or international intellectual property laws (see A/CN.9/WG.VI/WP.29, recommendation 4 (b)) and that the commentary would draw the attention of States to the need to adjust their laws in order to avoid any inconsistency. In addition, the Working Group noted that the commentary would list some examples of recommendations that might need to be adjusted, such as: recommendation 197 on the law applicable to security rights in intangible property; recommendations 41 and 79 on registration in a specialized registry; recommendation 83 (c) on a licensee in the ordinary course of business; and recommendations in which the question arose as to whether a security right in goods should extend to any intellectual property involved in their use or operation.

Recommendations 16 and 17 (assets subject to a security agreement)

117. It was agreed that, to avoid overriding statutory limitations to the transferability of assets (with the exception of the limited rules of recommendations 23 and 24 dealing with receivables), a new recommendation should be added in the draft Guide along the following lines:

“The law should provide that, except as provided in recommendations 23 and 24, it does not override provisions of any other law to the extent that they limit the creation or enforcement of a security right in, or the transferability of, specific types of asset.”

Recommendation 23 (effectiveness of an assignment made despite an anti-assignment clause)

118. It was agreed that the term “receivable” should be added after the term “assignment” so as to ensure that that recommendation (as well as all recommendations dealing with receivables) would apply only to receivables, and not to intellectual property.

Specialized registration

119. Noting that registration was not necessary for the creation of some intellectual property rights, such as copyright, and in order to avoid any implication that the draft Guide might require registration in that respect, it was agreed that the commentary should clarify that whether registration in a specialized registry was required was a matter for other law. It was also agreed that the commentary should also explain that, if other law required registration in a specialized registry, a right so registered would be superior to a right registered in the general security rights registry (see recommendation 79).

Recommendation 143 (disposition of encumbered assets)

120. In order to ensure that the secured creditor could enforce only the grantor’s rights in the encumbered asset, it was agreed that recommendation 143 should be revised along the following lines: “The law should provide that after default a secured creditor is entitled to sell or otherwise dispose of, lease or license an encumbered asset to the extent of the grantor’s rights in the encumbered asset.”

Other matters**Recommendation 195 (law applicable to a security right in tangible property)**

121. Recalling that it had deferred to a later time in the session discussion of the bracketed text in recommendation 195 (see para. 34), the Working Group resumed its discussion and requested the Secretariat to prepare a revised text and place it in square brackets for the consideration of the Commission. It was widely felt that the revised text should take into account the following considerations: refer to asset registration rather than specialized registration; refer also to title certificate systems; and refer to such a specialized registration system only if that system allowed registration of security rights.

Recommendation 197 (law applicable to a security right in intangible property)

122. Recalling its decision to delete the bracketed text in recommendation 197 (see para. 40) and its discussion of security rights in intellectual property (see para. 116), the Working Group agreed that the commentary should explain that recommendation 197 was not appropriate for security rights in intellectual property and that the matter should be considered in the context of future work.

Recommendation 208 (law applicable to a security right to payment of funds credited to a bank account)

123. Recalling its decision to retain both alternatives A and B, despite the predominant view in favour of alternative B and in view of the strongly-held views in favour of alternative A (see para. 57), the Working Group resumed its discussion in an effort to reach agreement. Another alternative along the following lines was suggested:

“(a) The law of that State in which the depositary bank conducts its operations, in the case where the depositary bank conducts operations in only one State;

“(b) Otherwise, the law of the State expressly stated in the account agreement as the State whose law governs the account agreement or, if the account agreement expressly provides that another law is applicable in all such issues, that other law. However, the law of the State determined pursuant to the preceding sentence applies only if the depositary bank has at the time of the conclusion of the account agreement, an office in that State that is engaged in the regular activity of maintaining bank accounts; or

“(c) If none of the above rules apply, the applicable law would be determined by fallback rules based on article 5 of the Hague Convention on the Law Applicable to Certain Rights of Securities Held with an Intermediary.”

124. That suggestion did not receive sufficient support. It was felt that it was essentially identical with alternative A.

125. With respect to alternative B, a number of suggestions were made. One suggestion was that reference should be made to “places of business in more than one State” rather than to “more than one place of business”. It was stated that if more than one place of business was in the same State, the same law would apply, except in the context of a multi-unit State, which would address the conflict of laws of its various units in its internal law. That suggestion received sufficient support.

126. Another suggestion was that reference should be made in alternative B to the law of the State whose law governed the bank-client relationship. That suggestion was objected to on the grounds that a branch might be subject both to the regulatory law of the State of its location and of the State in which the head office was located. It was also stated that regulatory law would apply irrespective of which law applied to the bank-client relationship. Yet another suggestion was that reference should be made in alternative B to the law of the State in which a bank account was opened, as a bank account could be maintained in another State, a fact that might not be known to the account holder or third parties. While interest was expressed in that suggestion, there was not sufficient support for it.

127. In the discussion, it was stated that one of the disadvantages of alternative B was that it was not appropriate for bank accounts opened through electronic means of communication with a bank, which might be incorporated in a certain jurisdiction without, however, maintaining a physical office in any State.

128. Subject to the change referred to above (see para. 125), the Working Group approved the substance of alternative B.

Special rules when the applicable law is the law of a multi-unit State

129. Recalling that, under recommendations 214 and 215, *renvoi* was allowed if the applicable law was the law of a multi-unit State (see para. 61), the Working Group agreed that the commentary should explain that those recommendations were applicable to federal States but not to other States with multiple units and jurisdictions in which application of *renvoi* could lead to great uncertainty with respect to the law applicable. It was widely felt that the commentary should also explain that in such States those recommendations would not need to be enacted into national law.

Rights and obligations of parties to acquisition financing transactions (non-unitary approach)

130. The Working Group agreed that the commentary should explain that the rights and obligations of parties to acquisition financing transactions (non-unitary approach) that would not be covered by recommendations 106 and 107 would be left to other law (e.g. sale or lease law). It was stated that such matters were typically addressed in general terms and conditions, which differed from case to case depending on the type of transaction involved.

V. Future work

131. It was noted that the thirteenth session of the Working Group was scheduled to take place in Vienna from 24 to 28 September 2007, those dates being subject to approval by the Commission at its fortieth session, which was scheduled to take place in Vienna from 25 June to 12 July 2007. The Working Group also noted that the draft Guide was expected to be considered by the Commission from 25 June to 2 July with final adoption expected to take place on 6 July 2007. In addition, the Working Group noted that from 9 to 12 July 2007 a congress on international trade law would take place in the context of the Commission session for delegates and experts to discuss relevant issues for future reference.

**D. Note by the Secretariat on the draft legislative guide on secured transactions,
submitted to the Working Group on Security Interests at its twelfth session
(A/CN.9/WG.VI/WP.31 and Add.1) [Original: English]**

A/CN.9/WG.VI/WP.31

Background remarks

1. At its thirty-third session, in 2000, the United Nations Commission on International Trade Law considered a report of the Secretary-General on possible future work in the area of secured credit law (A/CN.9/475). At that session, the Commission agreed that security interests was an important subject and had been brought to the attention of the Commission at the right time, in particular in view of the close link of security interests with the work of the Commission on insolvency law. It was widely felt that modern secured credit laws could have a significant impact on the availability and the cost of credit and thus on international trade. It was also widely felt that modern secured credit laws could alleviate the inequalities in the access to lower-cost credit between parties in developed countries and parties in developing countries, and in the share such parties had in the benefits of international trade. A note of caution was struck in that regard, however, to the effect that such laws needed to strike an appropriate balance in the treatment of privileged, secured and unsecured creditors so as to become acceptable to States. It was also stated that, in view of the divergent policies of States, a flexible approach aimed at the preparation of a set of principles with a guide, rather than a model law, would be advisable. Furthermore, in order to ensure the optimal benefits from law reform, including financial-crisis prevention, poverty reduction and facilitation of debt financing as an engine for economic growth, any effort on security interests would need to be coordinated with efforts on insolvency law.¹

2. At its thirty-fourth session, in 2001, the Commission considered a note by the Secretariat on security interests (A/CN.9/496). At that session, the Commission agreed that work should be undertaken in view of the beneficial economic impact of a modern secured credit law. It was stated that experience had shown that deficiencies in that area could have major negative effects on a country's economic and financial system. It was also stated that an effective and predictable legal framework had both short- and long-term macroeconomic benefits. In the short term, namely, when countries faced crises in their financial sector, an effective and predictable legal framework was necessary, in particular in terms of enforcement of financial claims, to assist the banks and other financial institutions in controlling the deterioration of their claims through quick enforcement mechanisms and to facilitate corporate restructuring by providing a vehicle that would create incentives for interim financing. In the longer term, a flexible and effective legal framework for security rights could serve as a useful tool to increase economic growth. Indeed, without access to affordable credit, economic growth, competitiveness and international trade could not be fostered, with enterprises being prevented from expanding to meet their full potential.² As to the form of work, the Commission

¹ *Official Records of the General Assembly, Fifty-fifth Session, Supplement No. 17 (A/55/17)*, para. 459.

² *Ibid.*, *Fifty-sixth Session, Supplement No. 17 (A/56/17)*, para. 351.

considered that a model law might be too rigid and noted the suggestions made for a set of principles with a legislative guide that would include, where feasible, model legislative provisions.³

3. After discussion, the Commission decided to entrust a working group with the task of developing “an efficient legal regime for security rights in goods involved in a commercial activity, including inventory, to identify the issues to be addressed, such as the form of the instrument, the exact scope of the assets that can serve as collateral, ...”.⁴ Emphasizing the importance of the matter and the need to consult with representatives of the relevant industry and practice, the Commission recommended that a two- to three-day colloquium be held.⁵

4. At its first session (New York, 20-24 May 2002), Working Group VI (Security Interests) had before it a first, preliminary draft legislative guide on secured transactions, prepared by the Secretariat (A/CN.9/WG.VI/WP.2 and Add.1-12), a report on an UNCITRAL-Commercial Finance Association international colloquium, held in Vienna from 20 to 22 March 2002 (A/CN.9/WG.VI/WP.3), and comments by the European Bank for Reconstruction and Development (A/CN.9/WG.VI/WP.4). At that session, the Working Group considered chapters I to V and X of the draft legislative guide (A/CN.9/WG.VI/WP.2 and Add.1-5 and 10), and requested the Secretariat to revise those chapters (A/CN.9/512, para. 12). At the same session, the Working Group considered suggestions for the presentation of modern registration systems in order to provide the Working Group with information necessary to address concerns expressed with respect to registration of security rights in movable property (see A/CN.9/512, para. 65). In addition, the Working Group agreed on the need to ensure, in cooperation with Working Group V (Insolvency Law), that issues relating to the treatment of security rights in insolvency proceedings would be addressed consistently with the conclusions of Working Group V on the intersection of the work of Working Group V and Working Group VI (see A/CN.9/512, para. 88; see also A/CN.9/511, paras. 126 and 127).

5. At its thirty-fifth session, in 2002, the Commission had before it the report of Working Group VI (Security Interests) on the work of its first session (A/CN.9/512). The Commission expressed its appreciation to the Working Group for the progress made in its work. It was widely felt that, with the legislative guide, the Commission had a great opportunity to assist States in adopting modern secured transactions legislation, which was generally thought to be a necessary, albeit not sufficient in itself, condition for increasing access to low-cost credit, thus facilitating the cross-border movement of goods and services, economic development and ultimately friendly relations among States.⁶ In that connection, the Commission noted with satisfaction that the project had attracted the attention of international, governmental and non-governmental organizations and that some of those took an active part in the deliberations of the Working Group. The comments submitted to Working Group VI, in particular by the European Bank for Reconstruction and Development (A/CN.9/WG.VI/WP.4), were mentioned as an indication of that interest.

6. At that session, the feeling was widely shared that the timing of the Commission’s initiative was most opportune both in view of the relevant legislative

³ Ibid., para. 357.

⁴ Ibid., para. 358.

⁵ Ibid., para. 359.

⁶ Ibid., *Fifty-seventh Session, Supplement No. 17* (A/57/17), para. 202.

initiatives under way at the national and the international level and in view of the Commission's own initiative in the field of insolvency law. In that connection, the Commission noted with particular satisfaction the efforts undertaken by Working Group V (Insolvency Law) and Working Group VI towards coordinating their work on a subject of common interest, such as the treatment of security rights in the case of insolvency proceedings. Strong support was expressed for such coordination, which was generally thought to be of crucial importance for providing States with comprehensive and consistent guidance with respect to the treatment of security rights in insolvency proceedings. The Commission endorsed a suggestion made to revise the insolvency chapter of the draft legislative guide on secured transactions in light of the core principles agreed by Working Groups V and VI (see A/CN.9/511, paras. 126 and 127 and A/CN.9/512, para. 88). The Commission stressed the need for continued coordination and requested the Secretariat to consider organizing a joint session of the two Working Groups in December 2002.⁷

7. After discussion, the Commission confirmed the mandate given at its thirty-fourth session to Working Group VI to develop an efficient legal regime for security rights in goods, including inventory. The Commission also confirmed that the mandate of the Working Group should be interpreted widely to ensure an appropriately flexible work product, which should take the form of a legislative guide.⁸

8. At its second session (Vienna, 17-20 December 2002), the Working Group considered chapters VI (Filing system), VII (Priority) and IX (Default and enforcement) (A/CN.9/WG.VI/WP.2/Add.6, 7 and 9) of the first preliminary draft guide on secured transactions, prepared by the Secretariat. At that session, the Working Group requested the Secretariat to prepare revised versions of those chapters (see A/CN.9/531, para. 15). In conjunction with that session and in accordance with suggestions made at the first session of the Working Group (see A/CN.9/512, para. 65), an informal presentation of the registration systems of security rights in movable property of New Zealand and Norway was held. Immediately before the second session of Working Group VI, Working Groups V (Insolvency Law) and VI (Security Interests) held their first joint session (Vienna, 16 and 17 December 2002), during which the revised version of former chapter X (new chapter IX; A/CN.9/WG.VI/WP.6/Add.5) on insolvency was considered. At the joint session, the Secretariat was requested to prepare a revised version of that chapter (see A/CN.9/535, para. 8).

9. At its third session (New York, 3-7 March 2003), Working Group VI considered chapters VIII (Pre-default rights and obligations of the parties), XI (Conflict of laws and territorial application) and XII (Transition) of the first preliminary draft guide on secured transactions (A/CN.9/WG.VI/WP.2/Add.8, 11 and 12) and chapters II (Basic approaches to security) and III (Creation) of the second version of the draft guide (A/CN.9/WG.VI/WP.6/Add.2 and 3) and requested the Secretariat to prepare revised versions of those chapters (A/CN.9/532, para. 13). In conjunction with that session, an informal presentation was made of the recently completed secured transactions law in Slovakia, which was supported by the World Bank and by the European Bank for Reconstruction and Development.

10. At its thirty-sixth session, in 2003, the Commission had before it the reports of Working Group VI (Security Interests) on the work of its second and third sessions

⁷ Ibid., para. 203.

⁸ Ibid., para. 204.

(A/CN.9/531 and A/CN.9/532), as well as the report of the first joint session of Working Groups V and VI (A/CN.9/535). The Commission commended Working Group VI for the progress in its work and expressed its appreciation to Working Group V and Working Group VI for the coordination of their work in relation to the treatment of security rights in insolvency proceedings. The Commission also noted with appreciation the presentation of modern registration systems of security rights in movable property.⁹

11. In addition, the Commission emphasized the importance of coordination with organizations with interest and expertise in the field of secured transactions law, such as the International Institute for the Unification of Private law (Unidroit), the Hague Conference on Private International Law, the World Bank, the International Monetary Fund, the European Bank for Reconstruction and Development and the Asian Development Bank. Reference was made to the current work of Unidroit on security rights in securities, to the World Bank's *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems* to the extent they concerned secured transactions, to the Model Law on Secured Transactions and the "Core principles for a secured transactions law" of the European Bank for Reconstruction and Development, to the Asian Development Bank's *Guide to Movable Registries* and to the Model Inter-American Law on Secured Transactions of 2002 prepared by the Organization of American States. Reference was also made to the need to coordinate with the Hague Conference with respect to the conflict-of-laws chapter of the draft legislative guide on secured transactions, in particular with respect to the law applicable to the enforcement of security rights in the case of insolvency.¹⁰

12. With respect to the scope of work, the Commission noted suggestions that the Working Group should consider covering, in addition to goods (including inventory), trade receivables, letters of credit, deposit accounts and intellectual property rights in view of their economic importance as security for credit. As to the substance of the draft legislative guide, the Commission noted statements that, while the draft guide should discuss various workable approaches, it should also include recommendations and that, if alternative recommendations had to be prepared, their relative merits, in particular for developing countries and for countries with economies in transition, should also be discussed.¹¹

13. After discussion, the Commission confirmed the mandate given at its thirty-fourth session to Working Group VI to develop an efficient legal regime for security rights in goods, including inventory, and its decision at its thirty-fifth session that the mandate should be interpreted widely to ensure an appropriate work product, which should take the form of a legislative guide. The Commission also confirmed that it was up to the Working Group to consider the exact scope of its work and, in particular, whether trade receivables, letters of credit, deposit accounts and intellectual and industrial property rights should be covered in the draft legislative guide.¹²

14. At its fourth session (Vienna, 8-12 September 2003), the Working Group considered chapters I (Introduction), II (Key objectives), IV (Creation) and IX (Insolvency) and paragraphs 1 to 41 of chapter VII (Priority) (A/CN.9/WG.VI/WP.6/Add.1 and 3 and A/CN.9/WG.VI/WP.9/Add.3 and 6) and requested the Secretariat to prepare revised versions of those chapters (see A/CN.9/543, para. 15).

⁹ Ibid., *Fifty-eighth Session, Supplement No. 17* (A/58/17), para. 217.

¹⁰ Ibid., para. 218.

¹¹ Ibid., paras. 220 and 221.

¹² Ibid., para. 222.

15. At its fifth session (New York, 22-25 March 2004), the Working Group considered the summary and recommendations of chapters V (Publicity), VII (Priority) and X (Conflict of laws) (A/CN.9/WG.VI/WP.9/Add.2, 3 and 7), and requested the Secretariat to prepare revised versions of those chapters (see A/CN.9/549, para. 16).

16. At their second joint session (New York, 26 and 29 March 2004), Working Groups V (Insolvency Law) and VI (Security Interests) considered the treatment of security rights in the draft legislative guide on insolvency law on the basis of document A/CN.9/WG.V/WP.71 (see A/CN.9/550, para. 11).

17. At its thirty-seventh session, in 2004, the Commission had before it the reports of Working Group VI (Security Interests) on the work of its fourth and fifth sessions (A/CN.9/543 and A/CN.9/549), as well as the report of the second joint session of Working Groups V and VI (A/CN.9/550). The Commission commended Working Group VI for the progress achieved thus far and expressed its appreciation to Working Groups V and VI for the progress made during their second joint session, at which they had considered pending issues of common interest.¹³

18. In addition, the Commission noted with appreciation the progress made by the Working Group in the coordination of its work on conflict of laws with the Hague Conference on Private International Law and in particular the plans for a joint meeting of experts. The Commission also commended the efforts to coordinate with Unidroit, which was preparing a text on security rights in securities. The Commission also expressed its appreciation for the coordination with the World Bank, which was preparing principles and guidelines for effective insolvency and creditor rights systems, and in particular for the agreement that the World Bank text would form with the draft legislative guide on secured transactions a single international standard.¹⁴

19. The Commission noted with interest that a preliminary consolidated set of recommendations might be ready by early 2005. The Commission also welcomed the preparation of additional chapters on various types of asset, such as negotiable instruments and documents, bank accounts, letters of credit and intellectual property rights. In that connection, while the importance of those types of asset was generally recognized, it was stated that including them in the draft guide should not be at the expense of slowing down work with respect to the core assets within the scope of the draft guide (i.e. goods, including inventory, and receivables).¹⁵

20. After discussion, the Commission confirmed the mandate given to Working Group VI at the thirty-fourth session of the Commission and subsequently confirmed at its thirty-fifth and thirty-sixth sessions. The Commission also requested the Working Group to expedite its work so as to submit the draft guide to the Commission for final adoption as soon as possible and, hopefully, in 2006.¹⁶

21. At its sixth session (Vienna, 27 September-1 October 2004), the Working Group considered chapters I (Introduction), II (Key objectives), III (Basic approaches to security), IV (Creation), V (Effectiveness against third parties), VII (Pre-default rights and obligations of the parties), VIII (Default and enforcement), X (Conflict of laws) and XI (Transition) (A/CN.9/WG.VI/WP.9/

¹³ Ibid., *Fifty-ninth Session, Supplement No. 17* (A/59/17), para. 75.

¹⁴ Ibid., para. 76.

¹⁵ Ibid., para. 77.

¹⁶ Ibid., para. 78.

Add.1, 4 and 8, A/CN.9/WG.VI/WP.11/Add.1 and 2, A/CN.9/WG.VI/WP.13 and A/CN.9/WG.VI/WP.14 and Add.2 and 4) and requested the Secretariat to revise those chapters to reflect the deliberations and decisions of the Working Group (see A/CN.9/570, para. 8). At that session, the Working Group noted with appreciation that the conflict-of-laws chapter of the guide was being prepared in close cooperation with the Hague Conference on Private International Law (see A/CN.9/570, para. 75).

22. At its seventh session (New York, 24-28 January 2005), the Working Group considered chapters X (Conflict of laws), XII (Acquisition financing devices) and XVI (Security rights in bank accounts) (A/CN.9/WG.VI/WP.16/Add.1, A/CN.9/WG.VI/WP.17 and Add.1 and A/CN.9/WG.VI/WP.18 and Add.1) and requested the Secretariat to revise those chapters to reflect the deliberations and decisions of the Working Group (see A/CN.9/574, para. 8).

23. At its thirty-eighth session, in 2005, the Commission had before it the reports of Working Group VI (Security Interests) on the work of its sixth and seventh sessions (A/CN.9/570 and A/CN.9/574). The Commission commended the Working Group for the progress achieved thus far, noted with interest the progress made by the Working Group in the coordination of its work with the Hague Conference on Private International Law, Unidroit, the World Bank and the World Intellectual Property Organization (WIPO) and requested the Working Group to expedite its work so as to submit the draft legislative guide to the Commission, at least for approval in principle, in 2006, and for final adoption in 2007.¹⁷

24. At its eighth session (Vienna, 5-9 September 2005), the Working Group considered recommendations in chapters VII (Pre-default rights and obligations of the parties), VIII (Default and enforcement), IX (Insolvency), X (Acquisition financing devices) and XI (Conflict of laws) (A/CN.9/WG.VI/WP.21/Add.2-5). It also considered terminology and recommendations related to (a) negotiable instruments and negotiable documents (definitions (w) and (x), as well as recommendations 3 (d) and 24 (see A/CN.9/WG.VI/WP.21 and A/CN.9/WG.VI/WP.22/Add.1); (b) proceeds from a drawing under an independent undertaking (definitions (y), (z), (aa) and (bb), as well as recommendations 25, 49, 62, 106 and 138) (see A/CN.9/WG.VI/WP.21/Add.1 and 5 and A/CN.9/WG.VI/WP.22/Add.1); and (c) intellectual property rights (definition (dd), and recommendation 3 (h)) (see A/CN.9/WG.VI/WP.21 and A/CN.9/WG.VI/WP.22/Add.1) (see A/CN.9/588, para. 8).

25. At its ninth session (New York, 30 January-3 February 2006), the Working Group considered recommendations in chapters V (Effectiveness against third parties), VI (Priority) and X (Acquisition financing devices) (see A/CN.9/WG.VI/WP.24/Add.3-5) and requested the Secretariat to revise those chapters to reflect the deliberations and decisions of the Working Group (see A/CN.9/593, para. 8). At that session, in view of the expectation of the Commission to approve in principle the substance of the recommendations of the draft guide at its thirty-ninth session, which was scheduled to take place in New York from 19 June to 7 July 2006, the Working Group agreed to hold an extra session, its tenth session, in New York from 1 to 5 May 2006 (see A/CN.9/593, para. 97).

26. At its tenth session (New York, 1-5 May 2006), the Working Group considered recommendations on security rights in receivables, negotiable instruments,

¹⁷ Ibid., *Sixtieth Session, Supplement No. 17* (A/60/17), paras. 186 and 187.

negotiable documents, rights to payment of funds credited to bank accounts, rights to proceeds under independent undertakings, as well as recommendations on pre-default rights and obligations of the parties and recommendations 88 to 111 on default and enforcement (see A/CN.9/WG.VI/WP.24 and Add.1 and 2 and A/CN.9/WG.VI/WP.26 and Add.1-3 and Add.3/Corr.1). The Secretariat was requested to revise those recommendations to reflect the deliberations and decisions of the Working Group (see A/CN.9/603, para. 8). At that session, the Working Group noted that the Commission was expected to approve in principle the substance (i.e. the policy, not the formulation) of the recommendations of the draft guide at its thirty-ninth session (New York, 19 June-7 July 2006).

27. At its thirty-ninth session, in 2006, the Commission had before it the reports of Working Group VI (Security Interests) on the work of its eighth, ninth and tenth sessions (A/CN.9/588, A/CN.9/593 and A/CN.9/603 respectively). The Commission expressed its satisfaction with the progress achieved thus far by Working Group VI (Security Interests) in developing a legislative guide on secured transactions and approved, in substance, the recommendations contained in documents A/CN.9/WG.VI/WP.21/Add.3, A/CN.9/WG.VI/WP.24 and Add.5, A/CN.9/WG.VI/WP.26/Add.4-8 and A/CN.9/611 and Add.1 and 2. After conclusion of its discussion of the recommendations of the draft guide, the Commission expressed its appreciation to the Working Group for the results achieved thus far in the development of the draft guide and noted that the views expressed and the suggestions made by the Commission would be taken into account in the subsequent version of the draft guide.¹⁸

28. At that session, the Commission noted that, as the draft guide dealt with security rights in intellectual property rights (such as patents, trademarks and copyrights) in general terms, more work might be required to provide guidance to States in that regard.¹⁹ After discussion, the Commission requested the Secretariat to prepare, in cooperation with relevant organizations and in particular WIPO, a note discussing the scope of future work of the Commission on security rights in intellectual property rights. In order to obtain the input of experts in Government and the private sector, the Commission requested the Secretariat to organize a colloquium.²⁰

¹⁸ Ibid., *Sixty-first Session, Supplement No. 17* (A/61/17), paras. 13 and 78.

¹⁹ Ibid., paras. 79-85.

²⁰ Ibid., para. 86.

A/CN.9/WG.VI/WP.31/Add.1 [Original: English]**Note by the Secretariat on the draft legislative guide on secured transactions, submitted to the Working Group on Security Interests at its twelfth session****ADDENDUM****CONTENTS**

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Introduction

A. Purpose of the Guide

1. The purpose of the UNCITRAL Legislative Guide on Secured Transactions (hereinafter referred to as “the Guide”) is to assist States in the development of modern secured transactions laws with a view to promoting the availability of low-cost secured credit. The Guide is intended to be useful to States that do not currently have efficient and effective secured transactions laws, as well as to States that already have workable laws but wish to review or modernize them, or to harmonize or coordinate their laws with those of other States.

2. The Guide is based on the premise that sound secured transactions laws can have significant economic benefits for States that adopt them, including attracting credit from domestic and foreign lenders and other credit providers, promoting the development and growth of domestic businesses (particularly small and medium-sized enterprises) and generally increasing trade. Such laws also benefit consumers by lowering prices for goods and services and making low-cost consumer credit more readily available. To be effective, such laws must be supported by efficient and effective judicial systems and other enforcement mechanisms. They must also be supported by insolvency laws that respect rights derived from secured transactions laws (see the UNCITRAL *Legislative Guide on Insolvency Law*¹).

3. The Guide seeks to rise above differences among legal regimes to suggest pragmatic and proven solutions that can be accepted and implemented in States having divergent legal traditions. The focus of the Guide is on developing laws that achieve practical economic benefits for States that adopt them. While it is possible

¹ United Nations publication, Sales No. E.05.V.10.

that States will have to incur predictable, yet limited, costs to develop and implement these laws, substantial experience suggests that the resulting short- and long-term benefits to such States should greatly outweigh the costs.

4. All businesses, whether manufacturers, distributors, service providers or retailers, require working capital to operate, to grow and to compete successfully in the marketplace. It is well established, through studies conducted by such organizations as the International Bank for Reconstruction and Development (the World Bank), the International Monetary Fund, the Asian Development Bank and the European Bank for Reconstruction and Development, that one of the most effective means of providing working capital to commercial enterprises is through secured credit.

5. The key to the effectiveness of secured credit is that it allows businesses to use the value inherent in their assets as a means of reducing risk for the creditor. Risk is reduced because credit secured by assets gives creditors access to the assets as another source of payment in the event of non-payment of the secured obligation. As the risk of non-payment is reduced, the availability of credit increases and the cost of credit falls.

6. A legal system that supports secured credit transactions is critical to reducing the perceived risks of credit transactions and promoting the availability of secured credit. Secured credit is more readily available to businesses in States that have efficient and effective laws that provide for consistent, predictable outcomes for creditors in the event of non-performance by debtors. On the other hand, in States that do not have efficient and effective laws, where creditors perceive the legal risks associated with credit transactions to be high, the cost of credit increases as creditors require increased compensation to evaluate and assume the increased risk. In some States, the absence of an efficient and effective secured transactions regime, or of an insolvency law regime under which security rights are recognized, has resulted in the virtual elimination of credit for small and medium-sized commercial enterprises, as well as for consumers.

7. By aiding in the cultivation and growth of individual businesses, creating a legal regime that promotes secured credit can have a positive effect upon the general economic prosperity of a State. Thus, States that do not have an efficient and effective secured transactions regime may deny themselves valuable economic benefits.

8. To best promote the availability of low-cost secured credit, the Guide suggests that secured transactions laws should be structured to enable businesses to utilize the value inherent in their property to the maximum extent possible to obtain credit. In this regard, the Guide adopts two of the most essential concepts of successful secured transactions laws, the concepts of priority and effectiveness against third parties. The concept of priority allows for the concurrent existence of security rights having different priority status in the same assets. This makes it possible for a business to utilize the value of its assets to the maximum extent possible to obtain secured credit from more than one creditor using the same assets as security, while at the same time allowing each creditor to know the priority of its security right. The concept of effectiveness against third parties, in the form of a system allowing, inter alia, the achievement of third-party effectiveness by registration of a simple notice concerning security rights, is designed to promote legal certainty with regard to the relative priority status of creditors and thus to reduce the risks and costs associated with secured transactions.

9. The legal regime envisaged in the Guide is a purely domestic regime. The recommendations of the Guide are addressed to national legislators considering reform of domestic secured transactions laws. However, because secured transactions often involve parties and assets located in different jurisdictions, the Guide also seeks to address the recognition of security rights and title-based security devices, such as retention of title and financial leases, effectively created in other jurisdictions. This would represent a marked improvement for the holders of those rights over the laws currently in effect in many States, under which such rights often are lost once an encumbered asset is transported across national borders, and would go far towards encouraging creditors to extend credit in cross-border transactions.

10. Throughout, the Guide seeks to establish a balance among the interests of debtors, creditors (whether secured, privileged or unsecured), affected third persons, buyers and other transferees, and the State. In so doing, the Guide adopts the premise, supported by substantial empirical evidence, that all creditors will accept such a balanced approach and will thereby be encouraged to extend credit, as long as the laws (and supporting legal and governmental infrastructure) are effective to enable the creditors to assess their risks with a high level of predictability and with confidence that they will ultimately realize the economic value of the encumbered assets in the event of non-payment by the debtor. Essential to this balance is a close coordination between the secured transactions and insolvency law regimes, including provisions pertaining to the treatment of security rights in the event of a reorganization or liquidation of a business. Additionally, certain debtors, such as consumer debtors, require additional protections. Thus, although the regime envisioned by the Guide will apply to many forms of consumer transactions, it is not intended to override consumer-protection laws or to discuss consumer-protection policies, since these matters do not lend themselves to unification.

11. In the same spirit, the Guide also addresses concerns that have been expressed with respect to secured credit. One such concern is that providing a creditor with a priority claim to all or substantially all of a person's assets may appear to limit the ability of that person to obtain financing from other sources. Another concern is the potential ability of a secured creditor to exercise influence over a business, to the extent that the creditor may seize, or threaten seizure of, the encumbered assets of that business upon default. Yet another concern is that in some cases secured creditors may take most or all of a person's assets in the case of insolvency and leave little for unsecured creditors, who may not be in a position to bargain for a security right in those assets. The Guide discusses these concerns and, in those situations where the concerns appear to have merit, suggests solutions.

12. The Guide builds on the work of UNCITRAL and other organizations. Such work includes the European Bank for Reconstruction and Development Model Law on Secured Transactions, completed in 1994; the European Bank for Reconstruction and Development "Core principles for a secured transactions law", completed in 1997; the Organization for Harmonization of Business Law in Africa Uniform Act Organizing Securities, prepared in 1997; the study on secured transactions law reform in Asia,² prepared by the Asian Development Bank in 2000; the United Nations Convention on the Assignment of Receivables in International Trade

² *Law and Policy Reform at the Asian Development Bank 2000*, vol. II (Asian Development Bank, 2000).

(United Nations Assignment Convention),³ adopted in 2001; the Convention on International Interests in Mobile Equipment, adopted in 2001, and the relevant protocols thereto; the Convention on the Law Applicable to Certain Rights in respect of Securities held with an Intermediary, adopted in 2001; the Organization of American States Model Inter-American Law on Secured Transactions, prepared in 2002; the UNCITRAL *Legislative Guide on Insolvency Law*, completed in 2004; [the Unidroit Convention on Substantive Rules regarding Intermediated Securities; and [...]].

B. Terminology and rules of interpretation

13. The Guide adopts terminology to express the concepts that underlie an effective secured transactions regime. The terms used are not drawn from any particular legal system. Even when a term appears to be the same as that found in a particular national law, the Guide does not intend to adopt the meaning of the term in that national law. Rather, the Guide provides definitions giving a specific meaning to each key term. Many definitions also have the effect of delimiting the scope of the recommendations in the Guide that use those terms. Some recommendations use terms that are defined in those recommendations and some definitions are further elaborated in recommendations that use a defined term. Thus, the scope and content of each recommendation depend on the meaning of the defined terms used.

14. The Guide's approach of using defined terms is taken to facilitate precise communication, independent of any particular national legal system, and to enable readers of the Guide to understand its recommendations uniformly, providing them with a common vocabulary and conceptual framework. The definitions should be read with care and should be referred to whenever the defined terms are encountered.

15. While the terms are not of themselves an imperative element of the Guide's recommendations, legislation based on the Guide will typically include specific definitions for the terms that are used. Even if the terms used in the legislation differ from those used in the Guide, the definitions provided in the terminology might be used. This would avoid unintended substantive change and would make it most likely that the terms used will be understood uniformly by judges, commercial parties and their counsel, both inside and outside of the enacting State, from the outset, to maximize uniform interpretation immediately upon the effective date of the new legislation, thereby avoiding periods of doubt pending judicial interpretation. Use of the terms and, more importantly, the definitions provided in the Guide will also encourage harmonization of the law governing security rights.

16. The word "or" is not intended to be exclusive; use of the singular also includes the plural and vice versa; "include" and "including" are not intended to indicate an exhaustive list; "may" indicates permission and "should" indicates instruction; and "such as" and "for example" are to be interpreted in the same manner as "include" or "including". "Creditors" should be interpreted as including both the creditors in the forum State and foreign creditors, unless otherwise specified. References to "person" should be interpreted as including both natural and legal persons, unless otherwise specified.

³ General Assembly resolution 56/81, annex.

17. Some States may choose to implement the recommendations of the Guide by enacting a single comprehensive statute (a method more likely to produce coherence and avoid errors of omission or misunderstanding), while other States may seek to modify their existing body of law by insertions of specific rules in various places. The Guide refers to the entire body of recommended rules, whichever method is chosen for implementation, as “the law” or “this law”.

18. The Guide also uses the term “law” in various other contexts. Except when otherwise expressly provided, throughout the Guide: (a) all references to law refer to both statutory and non-statutory law; (b) all references to law refer to internal law, excluding conflict-of-laws rules (so as to avoid *renvoi*); (c) all references to “law other than the secured transactions law” refer to the entire body of a State’s law (whether substantive or procedural) other than that embodying the law governing secured transactions over movable property (whether pre-existing or newly enacted or modified pursuant to the recommendations of the Guide); (d) all references to “the law governing ... (e.g., negotiable instruments)” refer not only to a special statute or body of law denominated as “negotiable instruments law” but include also all contract and other general law that might be applicable to transactions or situations involving a negotiable instrument; and (e) all references to “insolvency law” are similarly all-encompassing, but refer only to law that might be applicable after the commencement of an insolvency proceeding.

19. The following paragraphs identify the principal terms used and the core meaning given to them in the Guide. The meaning of these terms is further refined when they are used in subsequent chapters. Those chapters also define and use additional terms (as is the case, for example, with the insolvency chapter). The definitions should be read together with the relevant recommendations. The principal terms are defined as follows:

(a) “Security right” means a consensual property right in movable property and attachments that secure payment or other performance of one or more obligations, regardless of whether the parties have designated it as a security right. It includes acquisition security rights and non-acquisition security rights. With respect to receivables, security right also means the right acquired by an outright transfer of a receivable, as well as a transfer by way of security. In order to ensure that the general recommendations apply to security rights in receivables and to outright transfers of receivables, unless otherwise provided, references to a “security right” in the Guide also refer to the “right of an assignee”;

(b) “Acquisition security right” means [, in the context of a unitary approach,] a security right in an asset that secures the obligation to pay any unpaid portion of the purchase price of the asset or an obligation incurred to enable the grantor to acquire the asset. Acquisition security rights include not only rights that are denominated as security rights but also rights retained or derived under retention-of-title sales, hire-purchase transactions, financial leases and purchase-money lending transactions. “Grantor” of an acquisition security right includes a buyer, financial lessee or grantor in a purchase-money lending transaction. “Acquisition financier” means the secured creditor with an acquisition security right and includes a retention-of-title seller, financial lessor or purchase-money lender;

[*Note to the Working Group: See note after definition (b) in document A/CN.9/WG.VI/WP.29.*]

(c) “Secured obligation” means the obligation secured by a security right;

(d) “Secured creditor” means a creditor that has a security right. In order to ensure that the general recommendations apply to security rights in receivables and to outright transfers of receivables, unless otherwise provided, references to the “secured creditor” in the Guide also refer to the “assignee”;

(e) “Debtor” means a person that owes performance of the secured obligation [and includes secondary obligors, such as guarantors of a secured obligation]. The debtor may or may not be the person that grants the security right to a secured creditor (see grantor);

(f) “Grantor” means a person that creates a security right in one or more of its assets in favour of a secured creditor to secure either its own obligation or that of another person (see debtor of the receivable). In order to ensure that the general recommendations apply to security rights in receivables and to outright transfers of receivables, unless otherwise provided, references to the “grantor” in the Guide also refer to the “assignor”;

(g) “Security agreement” means an agreement between a grantor and a creditor, in whatever form or terminology, that creates a security right;

(h) “Encumbered asset” means tangible or intangible movable property that is subject to a security right;

(i) “Tangible property” means all forms of corporeal movable property. Among the categories of tangible property are inventory, equipment, attachments, negotiable instruments, negotiable documents and money;

(j) “Inventory” means a stock of tangible property held for sale or lease in the ordinary course of the grantor’s business and also raw and semi-processed materials (work-in-process);

(k) “Equipment” means tangible property used by a person in the operation of its business;

(l) “Attachments to immovable property” means tangible property that is so physically attached to immovable property that, despite the fact that it has not lost its separate identity, is treated as immovable property under the law of the State where the immovable property is located;

(m) “Attachments to movable property” means tangible property that is so physically attached to other tangible property that, despite the fact that it has not lost its separate identity, it is treated as part of that movable property under law other than this law;

(n) “Mass or product” means tangible property other than money that is so physically associated or united with other tangible property that it has lost its separate identity;

(o) “Intangible property” means all forms of movable property other than tangible property and includes incorporeal rights, receivables and rights to the performance of obligations other than receivables;

(p) “Receivable” means a right to payment of a monetary obligation and a contractual right to performance of a non-monetary obligation excluding rights to payment evidenced by a negotiable instrument, the obligation to pay under an independent undertaking and the obligation of a bank to pay funds credited to a bank account;

[Note to the Working Group: See note after definition (p) in document A/CN.9/WG.VI/WP.29.]

(q) “Assignment” means the creation of a security right in a receivable and includes an outright transfer of a receivable. The creation of a security right in a receivable includes an outright transfer by way of security;

(r) “Assignor” means the person that makes an assignment of a receivable;

(s) “Assignee” means the person to which an assignment of a receivable is made;

(t) “Subsequent assignment” means an assignment by the initial or any other assignee. In the case of a subsequent assignment, the person that makes that assignment is the assignor and the person to which that assignment is made is the assignee;

(u) “Debtor of the receivable” means a person liable for payment of a receivable. “Debtor of the receivable” includes a guarantor or other person secondarily liable on the receivable.

A guarantor is not only a debtor of the receivable, the payment of which it has guaranteed, but also a debtor of the receivable that is constituted by the guarantee, as a guarantee is itself a receivable (i.e. there are two receivables);

(v) “Notice” means a communication in writing, except where otherwise provided in the Guide;

(w) “Notification of the assignment” means a communication in writing that reasonably identifies the assigned receivable and the assignee. The writing requirement is met by an electronic communication if the information contained therein is accessible so as to be usable for subsequent reference (see article 6 of the UNCITRAL Model Law on Electronic Commerce⁴ and article 9, paragraph 2, of the United Nations Convention on the Use of Electronic Communications in International Contracts⁵);

[Note to the Working Group: See note after definition (v) in document A/CN.9/WG.VI/WP.29.]

(x) “Original contract” in the context of an assignment means the contract between the assignor and the debtor of the receivable from which the receivable arises. With respect to non-contractual receivables, “original contract” means the non-contractual source of the receivable;

(y) “Negotiable instrument” means an instrument that embodies a right to payment, such as a cheque, bill of exchange or promissory note, which satisfies the requirements for negotiability under the law governing negotiable instruments;

(z) “Negotiable document” means a document that embodies a right for delivery of tangible property, such as a warehouse receipt or a bill of lading, and satisfies the requirements for negotiability under the law governing negotiable documents;

(aa) “Independent undertaking” means a letter of credit (commercial or standby), a confirmation of a letter of credit, an independent guarantee (demand,

⁴ United Nations publication, Sales No. E.99.V.4.

⁵ General Assembly resolution 60/21, annex.

first demand, bank guarantee or counter-guarantee) or any other undertaking recognized as independent by law or practice rules, such as the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit (“the United Nations Guarantee and Stand-by Convention”), the Uniform Customs and Practice for Documentary Credits, the rules on International Standby Practices, and the Uniform Rules for Demand Guarantees;

(bb) “Proceeds under an independent undertaking” means the right to receive a payment due, a draft accepted or deferred payment incurred or another item of value, in each case to be delivered by the guarantor/issuer honouring or by a nominated person giving value for a draw under an independent undertaking. The term does not include:

- (i) The right to draw (i.e. to request payment) under an independent undertaking; or
- (ii) What is received upon honour of an independent undertaking or upon disposition of proceeds under an independent undertaking (i.e. the proceeds derived from collection or disposition of the proceeds under an independent undertaking).

This definition refers to “proceeds under an independent undertaking” to be consistent with terminology generally used in independent undertaking law and practice. The term as used in the Guide means the right of the grantor as beneficiary of an independent undertaking to receive whatever payment or other value is given under the independent undertaking contingent upon the beneficiary’s compliance with the terms and conditions of the independent undertaking. The term does not include the proceeds themselves, i.e. what is actually received upon honour of a drawing by the guarantor/issuer, confirmer or nominated person (a beneficiary’s receipt of value from a negotiating bank should not be characterized as honour or disposition) or upon disposition of a right to proceeds under an independent undertaking.

The term “proceeds under an independent undertaking” refers to a right to receive even though the term “proceeds” as used in independent undertaking law and practice may refer either to the right to receive or to whatever is received under the independent undertaking, and even though the term “proceeds” as used elsewhere in the Guide refers to whatever is received. A security right in proceeds under an independent undertaking (as an original encumbered asset) is different from a security right in “proceeds” (a key concept of the Guide) of assets covered in the Guide;

(cc) “Guarantor/issuer” means a bank or other person that issues an independent undertaking;

(dd) “Confirmer” means a bank or other person that adds its own independent undertaking to that of the guarantor/issuer.

In line with article 6 (e) of the United Nations Guarantee and Stand-by Convention, a confirmation provides the beneficiary with the option of demanding payment from the confirmer in conformity with the terms and conditions of the confirmed independent undertaking instead of from the guarantor/issuer;

(ee) “Nominated person” means a bank or other person that is identified in an independent undertaking by name or type (e.g. “any bank in country X”) as being nominated to give value under an independent undertaking and that acts pursuant to that nomination;

(ff) A secured creditor has “control” with respect to proceeds under an independent undertaking:

- (i) Automatically upon the creation of the security right if the guarantor/issuer, confirmer or nominated person is the secured creditor; or
- (ii) If the guarantor/issuer, confirmer or nominated person has made an acknowledgment in favour of the secured creditor;

(gg) “Acknowledgment” with respect to proceeds under an independent undertaking means that the guarantor/issuer, confirmer or nominated person that will pay or otherwise give value upon a draw under an independent undertaking has, unilaterally or by agreement:

- (i) Acknowledged or consented to (however acknowledgement or consent is evidenced) the creation of a security right (whether denominated as an assignment or otherwise) in favour of the secured creditor in the proceeds from an independent undertaking; or
- (ii) Has obligated itself to pay or give value to the secured creditor upon a draw under an independent undertaking;

(hh) “Bank account” means an account that is maintained by a bank into which funds may be deposited or credited. The term includes a checking or other current account, as well as a savings or time-deposit account. The term does not include a claim against the bank evidenced by a negotiable instrument.

The right to payment of funds credited to a bank account covers a right to the payment of funds transferred into an internal account of the bank and not applied to any obligations owing to the bank. Funds transferred to the bank by way of anticipated reimbursement of a future payment obligation that the bank has accepted in the ordinary course of its banking business is also covered to the extent that the person that gave the bank instructions has a claim to those funds if the bank does not make the future payment;

(i) A secured creditor has “control” with respect to a right to payment of funds credited to a bank account:

- (i) Automatically upon the creation of a security right if the depositary bank is the secured creditor;
- (ii) If the depositary bank has concluded a control agreement evidenced by an authenticated record with the grantor and the secured creditor, according to which the depositary bank has agreed to follow instructions from the secured creditor with respect to the payment of funds credited to the bank account without further consent of the grantor; or
- (iii) If the secured creditor is the account holder.

There is no obligation on a depositary bank to enter into a control agreement. In addition, a secured creditor’s rights will be subject to the rights and obligations of the depositary bank under law and practice governing bank accounts. Moreover, a control agreement requires the consent of the grantor (as well as of the depositary bank) and the grantor retains the right to deal with the funds in the bank account until the secured creditor instructs the depositary bank otherwise (although in some control agreements, the funds would be blocked from the time of the conclusion of the control agreement). This covers situations where: (a) an existing account is

transferred to the secured creditor, (b) the secured creditor agrees with the grantor that funds should be deposited to an account to be opened later, and (c) the secured creditor is the only account holder (i.e. not merely a joint account holder);

(jj) “Intellectual property right” includes patents, trademarks, service marks, trade secrets, copyright and related rights and designs. It also includes rights of a licensee under licences of such rights;

(kk) “Proceeds” means whatever is received in respect of encumbered assets, including what is received as a result of sale or other disposition or collection, lease or licence of an encumbered asset, proceeds of proceeds, civil and natural fruits, dividends, distributions, insurance proceeds and claims arising from defects, damage to or loss of an encumbered asset;

(ll) “Priority” means the right of a person to derive the economic benefit of its security right in an encumbered asset in preference to a competing claimant;

(mm) “Competing claimant” means:

(i) Another secured creditor with a security right in the same encumbered asset (whether as an original encumbered asset or proceeds);

(ii) In the context of the non-unitary system for acquisition security rights, the seller, financial lessor or purchase-money lender of the same encumbered asset that has retained title to it;

(iii) Another creditor of the grantor that has a right in the same encumbered asset (e.g. by operation of law, attachment or seizure or similar process);

(iv) The insolvency representative in the insolvency of the grantor;⁶ or

(v) Any buyer or other transferee (including a lessee or licensee) of the encumbered asset;

(nn) “Possessory security right” means a security right in tangible property that is in the possession of the secured creditor;

(oo) “Non-possessory security right” means a security right in tangible property that is not in the possession of the secured creditor;

[Note to the Working Group: See note after definition (nn) in document A/CN.9/WG.VI/ WP.29.]

(pp) “Possession”, except as the term is used in recommendations 27 and 48 to 50 with respect to the issuer of a negotiable document, means the actual possession of tangible property by a person or an agent or employee of that person, or by an independent person that acknowledges that it holds for that person. It does not include constructive, fictive, deemed or symbolic possession;

(qq) “Issuer” of a negotiable document means the person who is obligated to deliver the tangible property covered by the document under the law governing negotiable documents.

In the case of a so-called multimodal bill of lading (if it qualifies as a negotiable document under the applicable law), the “issuer” may be a person who

⁶ In the chapter on insolvency, reference is made to “the insolvency of the debtor” for reasons of consistency with the terminology used in the UNCITRAL *Legislative Guide on Insolvency Law* (see footnote 55 of document A/CN.9/WG.VI/ WP.29, chapter XI on insolvency).

subcontracts various portions of the transport of the goods to other persons but still takes responsibility for their transport and for any damage that might occur during carriage;

(rr) “Insolvency court” means a judicial or other authority competent to control or supervise an insolvency proceeding;

(ss) “Insolvency estate” means assets and rights of the debtor that are controlled or supervised by the insolvency representative and subject to the insolvency proceedings;

(tt) “Insolvency proceedings” means collective judicial or administrative proceedings for the purposes of either reorganization or liquidation of the debtor’s business conducted according to the insolvency law;

(uu) “Insolvency representative” means a person or body responsible for administering the insolvency estate;

(vv) “Buyer in the ordinary course of business” means a person that buys inventory in the ordinary course of the seller’s business from a seller in the business of selling tangible property of that kind and without knowledge that the sale violates the rights of the secured creditor under the security agreement [or other rights of another person in the property];

(ww) “Lessee in the ordinary course of business” means a person that leases inventory in the lessor’s ordinary course from a lessor in the business of leasing tangible property of that kind and without knowledge that the lease violates the rights of the secured creditor under the security agreement [or other rights of another person in the property];

(xx) “Licensee in the ordinary course of business” means a person that licenses intangible property in the licensor’s ordinary course from a licensor in the business of licensing property of that kind and without knowledge that the licence violates the rights of the secured creditor under the security agreement [or other rights of another person in the property].

The terms “buyer in the ordinary course of business”, “lessee in the ordinary course of business” and “licensee in the ordinary course of business” are referred to in recommendation 83 dealing with the rights of buyers, lessees and licensees of encumbered assets (see A/CN.9/WG.VI/WP.29, chap. VII). It is possible for a buyer, lessee or licensee to know of the existence of a security right but not know whether the transfer violates the terms of the security agreement. In the rare cases in which the buyer of inventory has knowledge not only of the security right but also that the sale violates the terms of the security agreement, the buyer will not qualify as a buyer in the ordinary course of business and, therefore, not take free under recommendation 83, subparagraph (a). The test in recommendation 83 is the same as in recommendations 94 (priority of a security right in a right to payment of funds credited to a bank account) and 95 (priority of a security right in money);

(yy) “Consumer goods” means goods that the grantor uses or intends to use for personal, family or household purposes.

I. Key objectives of an effective and efficient secured transactions regime

20. In the spirit of providing practical, effective solutions, the Guide explores and develops the following key objectives and themes of an effective and efficient secured transactions regime. These objectives are designed to provide a broad policy framework for the establishment and development of such a regime.

A. Promoting secured credit

21. The primary overall objective of the Guide is to promote low-cost secured credit for persons in jurisdictions that adopt legislation based on the Guide's recommendations, thereby enabling such persons and the economy as a whole to obtain the economic benefits that flow from access to such credit (see para. 2 above).

B. Allowing utilization of the full value inherent in a broad range of assets to support credit in the widest possible array of credit transactions

22. A key to a successful legal regime governing secured transactions is to enable a broad array of businesses to utilize the full value inherent in their assets to obtain credit in a broad array of credit transactions. In order to achieve this objective, the Guide emphasizes the importance of comprehensiveness, by: (a) permitting a broad range of assets (including present and future assets) to serve as encumbered assets; (b) permitting the widest possible array of obligations (including future and conditional and monetary and non-monetary obligations) to be secured by security rights in encumbered assets; and (c) extending the benefits of the regime to the widest possible array of debtors, creditors and credit transactions.

C. Enabling parties to obtain security rights in a simple and efficient manner

23. The cost of credit will be reduced if security rights can be obtained in an efficient manner. For this reason, the Guide suggests methods for streamlining the procedures for obtaining security rights and otherwise reducing transaction costs. These methods include eliminating unnecessary formalities; providing for a single method for creating security rights rather than a multiplicity of security devices for different kinds of encumbered assets; and permitting security rights in future assets and for future advances of credit without any additional documentation or actions by the parties.

D. Providing for equal treatment of diverse sources of credit

24. Because healthy competition among all potential creditors is an effective way of reducing the cost of credit, the Guide recommends that the secured transactions

regime apply equally to various creditors, including banks and other financial institutions, as well as domestic and non-domestic creditors.

E. Validating non-possessory security rights

25. Because the granting of a security right should not make it difficult or impossible for the debtor or other grantor to continue to operate its business, the Guide recommends that the legal regime provide for non-possessory security rights in a broad range of assets coupled with a mechanism in the form of a public registry system for publicizing the existence of such security rights.

F. Encouraging responsible behaviour on the part of all parties by enhancing predictability and transparency

26. Because an effective secured transactions regime should also encourage responsible behaviour by all parties to a credit transaction, the Guide seeks to promote predictability and transparency to enable the parties to assess all relevant legal issues and to establish appropriate consequences for non-compliance with applicable rules, while at the same time respecting and addressing confidentiality concerns.

G. Establishing clear and predictable priority rules

27. A security right will have little or no value to a creditor unless the creditor is able to ascertain, at the time a transaction takes place, its priority in the property relative to other creditors (including an insolvency representative). Thus, the Guide proposes the establishment of a system for registering public notices with respect to security rights and, based on that system, clear rules that allow creditors to determine the priority of their security rights at the outset of the transaction in a reliable, timely and cost-efficient manner.

H. Facilitating enforcement of creditors' rights in a predictable and efficient manner

28. A security right will also have little or no value to a creditor unless the creditor is able to enforce the security right in a predictable and efficient manner. Thus, the Guide proposes procedures that allow creditors to so enforce their security rights, subject to judicial or other official control, supervision or review when appropriate. The Guide also recommends that there be a close coordination between a State's secured transactions laws and its insolvency laws with a view to respecting the pre-insolvency effectiveness and priority, as well as the economic value, of a security right subject to the appropriate rules of insolvency law.

I. Balancing the interests of affected persons

29. Because secured transactions affect the interests of various persons, including the debtor, other grantors, competing creditors, such as secured, privileged and

unsecured creditors, purchasers and other transferees, and the State, the Guide proposes rules that take into account their legitimate interests and seek to achieve, in a balanced way, all the objectives mentioned above.

J. Recognition of party autonomy

30. Because an effective secured transactions regime should provide maximum flexibility and durability to encompass a broad array of credit transactions, and also accommodate new and evolving forms of credit transactions, the Guide stresses the need to keep mandatory rules to a minimum so that parties may tailor their credit transactions to their specific needs. At the same time, the Guide takes into account that other legislation may protect the legitimate interests of consumers or other persons and specifies that a secured transactions regime should not override such legislation.

K. Harmonization of secured transactions laws, including conflict-of-laws rules

31. Adoption of legislation based on the recommendations contained in the Guide will result in harmonization of secured transactions laws (through the adoption of similar substantive laws which will facilitate the cross-border recognition of security rights). This result in itself will promote the financing of international trade and the movement of goods and services across national borders. Furthermore, to the extent complete harmonization of national secured transactions laws might not be achieved, conflict rules would be particularly useful to facilitate cross-border transactions. In any event, conflict-of-laws rules would be useful in order, for example, to help secured creditors determine how to make their security rights effective against third parties.

Recommendation 1 [Note to the Working Group: The Working Group may wish to note that the recommendations will be set out immediately after the relevant commentary. Accordingly, recommendation 1 will be inserted here in the final version of the Guide.]

II. Scope of the Legislative Guide

32. The regime envisioned by the Guide is intended to be a single, comprehensive regime for secured transactions, affecting the widest possible array of assets, parties, secured obligations, security rights and financing practices.

A. Assets covered

33. The primary focus of the Guide is on core commercial assets, such as commercial goods (inventory and equipment) and trade receivables. However, the Guide proposes that all types of assets are capable of being the object of a security right, including all present and future assets of a business, and covers all assets, both tangible and intangible, with the exception of assets specifically excluded.

34. The Guide covers all types of movable property and attachment, tangible or intangible, present or future, including inventory, equipment and other goods,

contractual and non-contractual receivables, contractual non-monetary obligations, negotiable instruments, negotiable documents, rights to payment of funds credited to a bank account, proceeds under an independent undertaking, and intellectual property rights. With respect to receivables, the general recommendations, as supplemented by the recommendations on receivables apply both to: (a) contractual and non-contractual receivables, except that recommendations 22 (effectiveness of a bulk assignment and an assignment of future, parts of, and undivided interests in receivables) and 109 (representations of the assignor) do not apply to non-contractual receivables; and (b) contractual non-monetary obligations. Law other than the law recommended in the Guide applies to the rights of obligors of contractual non-monetary obligations.

35. Some assets, such as aircraft, railway rolling stock, space objects, ships and intellectual property rights are in whole or in part subject to special laws. Security rights in such assets are covered by the Guide but, in the case of any inconsistency between such a special law and secured transactions law, the special law (e.g. the special registration system) prevails to the extent of the inconsistency. Where a direct inconsistency exists, the law should expressly confirm that the special laws and international obligations govern those assets to the extent of that inconsistency. The reference to aircraft, railway rolling stock, space objects, ships and intellectual property rights should be understood pursuant to the meaning of those terms in national law or international conventions dealing with them.

36. In developing its secured transactions law, a State should take account of the increasing importance and economic value of intellectual property assets to companies seeking to obtain low-cost secured credit.

37. A State enacting secured transactions legislation in accordance with the Guide should consider whether it might be appropriate to adjust certain of those recommendations as they apply to intellectual property rights. In this regard, a State should examine its existing intellectual property laws and the State's obligations under international conventions and, if the recommendations of the Guide are inconsistent with any such laws or conventions, the State's secured transactions law should confirm that those existing laws and conventions govern such issues to the extent of the inconsistency. In considering whether any adjustments of the recommendations as they apply to security rights in intellectual property are appropriate, a State should analyse each circumstance on an issue-by-issue basis and should have proper regard both to establishing an efficient secured transactions regime and to ensuring the protection and exercise of intellectual property rights in accordance with international conventions and national laws.

38. The Guide stresses the need to enable a grantor to create security rights not only in its existing assets but also in its future assets (i.e. assets acquired or created after the conclusion of the security agreement), without requiring the grantor or secured creditor to execute any additional documents or to take any additional action at the time such assets are acquired or created. This approach is consistent, for example, with the United Nations Assignment Convention, which provides for the creation of security rights in future receivables without requiring any additional steps to be taken. In addition, the Guide recommends recognition of a security right in all existing and future assets of a business grantor through a single security agreement, a concept that already exists in some legal systems as an "enterprise mortgage" or as a combination of fixed and floating charges.

B. Assets excluded

39. Immovable property, securities and employment payments are types of asset that are subject to an outright exclusion from the Guide.

40. Immovable property (with the exception of attachments, which are covered by the Guide and can be subjected to security rights) is excluded as it raises different issues and is subject to a special title registration system indexed by asset and not by grantor.

41. In addition, the Guide does not cover security rights in securities because the nature of securities and their importance for the functioning of financial markets raise a broad range of issues that merit special legislative treatment. The substantive law issues relating to security and other rights in securities held with an intermediary are dealt with in a draft convention being prepared by the International Institute for the Unification of Private Law (Unidroit).

42. The private international law issues with respect to that subject matter are not addressed in the Guide since they are dealt with in the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities (The Hague, December 2002).

43. The Guide is structured in such a way that the State enacting legislation based on the regime envisaged in the Guide can, at the same time, implement the texts prepared by Unidroit and the Hague Conference, as well as relevant texts prepared by UNCITRAL, such as the United Nations Convention on the Assignment of Receivables in International Trade (New York, December 2001; hereinafter referred to as “the United Nations Assignment Convention”) and the UNCITRAL *Legislative Guide on Insolvency Law*.

44. Although immovable property and securities are excluded from the scope of the Guide as original encumbered assets, they may be affected by the Guide’s recommendations. If a security right in a mortgage or securities secures a receivable, negotiable instrument or other obligation and the receivable, negotiable instrument or other obligation is assigned, the security right in the securities or the mortgage follows. This rule does not affect any third-party rights, priority and enforcement requirements existing under immovable property law or securities law. For example, the priority of a security right in intermediated securities will be determined under securities law (see A/CN.9/WG.VI/WP.29, chap. IV, recommendation 24, and chap. V, recommendation 45).

[Note to the Working Group: The Working Group may wish to note that whether directly held securities and whether immovable property or securities as proceeds are to be covered remain open questions (see A/CN.9/WG.VI/WP.29, chap. II, note to recommendation 5).]

45. Security rights in employment payments are excluded based on the policy of protecting individual and family life. Any additional exclusions based on competing policy objectives should be limited in number and in scope, should be clearly stated in the law and should be adopted only after their potential benefit has been carefully weighed against the social and economic policy of promoting the availability of low-cost credit which underlies the secured transactions law envisaged in the Guide.

C. Parties covered

46. Any person, physical or legal, may be a debtor, grantor or secured creditor under the Guide. The Guide may also apply to consumers as there is no reason why consumers should be deprived of the benefits of the regime envisaged in the Guide. However, to the extent a rule of the regime envisaged in the Guide conflicts with consumer-protection law, consumer-protection law would prevail. States that do not have a body of law for the protection of consumers may wish to consider whether the enactment of a law based on the recommendations of the Guide would affect the rights of consumers and would thus require the introduction of consumer-protection legislation.

D. Obligations covered

47. The Guide also recommends that a broad range of obligations, monetary and non-monetary, may be secured and that both physical and legal persons may be parties to a secured transaction, including consumers, subject to consumer-protection laws. In addition, the Guide is intended to cover a broad range of transactions that serve security functions, including those related to possessory and non-possessory security rights, as well as transactions not denominated as secured transactions (such as retention of title, transfer of title for security purposes, assignment of receivables for security purposes, financial leases, and sale and leaseback transactions and the like).

E. Rights covered

48. The Guide deals with consensual security rights. However, it contains references to non-consensual rights, such as those provided by statute or judicial process, when the same property is subject to both consensual and non-consensual security rights and the law must provide for the relative priority of such rights (see A/CN.9/WG.VI/WP.29, chap. VII, recommendations 85-88).

49. To ensure a comprehensive coverage of all devices that serve security functions, the Guide also deals with rights that, while they are not denominated as security rights, nevertheless serve security purposes (see A/CN.9/WG.VI/WP.29, chap. XII, recommendations 182-194).

50. The Guide also deals with rights that are not security rights (i.e. outright sales of receivables) where it is necessary to avoid characterization issues and to ensure that the registry system and the priority rules of the Guide apply to all such rights.

F. Examples of financing practices covered in the Legislative Guide

51. Set forth below are short examples of the types of secured credit transactions that the Guide is designed to encourage and to which reference will be made throughout the Guide to illustrate specific points. These examples represent only a few of the numerous forms of secured credit transactions currently in use and an effective secured transactions regime must be sufficiently flexible to accommodate many existing methods of financing, as well as methods that may evolve in the future.

1. Inventory and equipment acquisition financing

52. Businesses often obtain financing for specific purchases of inventory or equipment. In many cases, the financing is provided by the seller of the tangible property (inventory and equipment) purchased. In other cases, the financing is provided by a lender. Sometimes the lender is an independent third party, but in other cases the lender may be an affiliate of the seller. The seller retains title or the lender is granted a security right in the tangible property purchased to secure the repayment of the credit or loan.

53. Here is an illustration of acquisition financing: ABC Manufacturing Company (ABC), a manufacturer of furniture, wishes to acquire certain inventory and equipment for use in manufacturing operations. ABC desires to purchase paint (constituting raw materials and, therefore, inventory) from Vendor A. ABC also wishes to purchase certain drill presses (constituting equipment) from Vendor B and certain conveyor equipment from Vendor C. Finally, ABC wishes to lease certain computer equipment from Lessor A.

54. Under the purchase agreement with Vendor A, ABC is required to pay the purchase price for the paint within 30 days of Vendor A's invoice to ABC, and ABC grants to Vendor A a security right in the paint to secure the purchase price. Under the purchase agreement with Vendor B, ABC is required to pay the purchase price for the drill presses within 10 days after they are delivered to ABC's plant. ABC obtains a loan from Lender A to finance the purchase of the drill presses from Vendor B, secured by a security right in the drill presses. ABC also maintains a bank account with Lender A and has granted Lender A a security right in the bank account as additional security for the repayment of the loan.

55. Under the purchase agreement with Vendor C, ABC is required to pay the purchase price for the conveyor equipment when it is installed in ABC's plant and rendered operational. ABC obtains a loan from Lender B to finance the purchase and installation of the conveyor equipment from Vendor C, secured by a security right in the conveyor equipment.

56. Under the lease agreement with Lessor A, ABC leases the computer equipment from Lessor A for a period of two years. ABC is required to make monthly lease payments during the lease term. ABC has the option (but not the obligation) to purchase the equipment for a nominal purchase price at the end of the lease term. Lessor A retains title to the equipment during the lease term but title will be transferred to ABC at the end of the lease term if ABC exercises the purchase option. This type of lease is often referred to as a "financial lease". Under some forms of financial lease, title to the leased property is transferred to the lessee automatically at the end of the lease term. A financial lease is to be distinguished from what is usually called an "operating lease". Under an operating lease, the leased property is expected to have a remaining useful life at the end of the lease term and the lessee does not have an option to purchase the leased property at the end of the lease term for a nominal price, nor is title to the leased property transferred to the lessee automatically at the end of the lease term.

57. In each of the above four cases, the acquisitions are made possible by means of acquisition financing provided by another person (seller, lender or financial lessor) who holds rights in the acquired property for the purpose of securing the acquisition financing granted. As the illustrations make clear, acquisition financing can occur with respect to both inventory and equipment.

2. Inventory and receivable revolving loan financing

58. Businesses generally have to expend capital before they are able to generate and collect revenues. For example, before a typical manufacturer can generate receivables and collect payments, the manufacturer must expend capital to purchase raw materials, to convert the raw materials into finished goods and to sell the finished goods. Depending on the type of business, this process may take up to several months. Access to working capital is critical to bridge the period between cash expenditures and revenue collections.

59. One highly effective method of providing such working capital is a revolving loan facility. Under this type of credit facility, loans secured by the borrower's existing and future inventory and receivables are made from time to time at the request of the borrower to fund the borrower's working capital needs. The borrower typically requests loans when it needs to purchase and manufacture inventory, and repays the loans when the inventory is sold and the sales price is collected. Thus, borrowings and repayments are frequent (though not necessarily regular) and the amount of the credit is constantly fluctuating. Because the revolving loan structure matches borrowings to the borrower's cash conversion cycle (that is, acquiring inventory, processing inventory, selling inventory, creating receivables, receiving payment and acquiring more inventory to begin the cycle again), this structure is, from an economic standpoint, highly efficient and beneficial to the borrower, and helps the borrower to avoid borrowing more than it actually needs.

60. Here is an illustration of this type of financing: It typically takes four months for ABC to manufacture, sell and collect the sales price for its products. Lender B agrees to provide a revolving loan facility to ABC to finance this process. Under the loan facility, ABC may obtain loans from time to time in an aggregate amount of up to 50 per cent of the value of its inventory that Lender B deems to be acceptable for borrowing (based upon the type and quality of the inventory, as well as other criteria) and of up to 80 per cent of the value of its receivables that Lender B deems to be acceptable for borrowing (based upon criteria such as the creditworthiness of the account debtors). ABC is expected to repay these loans from time to time as it receives payments from its customers. The loan facility is secured by all of ABC's existing and future inventory and receivables. In this type of financing, it is also common for the lender to obtain a security right in the bank account into which customer payments (i.e. the proceeds of inventory and receivables) are deposited.

3. Factoring

61. Factoring is a highly effective form of receivables financing that can trace its roots back thousands of years. In general, factoring involves the outright purchase of receivables from the grantor, as seller (assignor) to the factor (assignee). Such an outright transfer of receivables falls within the definition of a security right for purposes of the Guide (see definition (a) "security right" above).

62. There are a number of different types of factoring arrangement. The factor may pay a portion of the purchase price for the receivables at the time of the purchase ("discount factoring"), only when the receivables are collected ("collection factoring"), or on the average maturity date of all of the factored receivables ("maturity factoring"). The assignment of the receivables can be with or without recourse to the assignor in the event of non-payment of the receivables by the debtors of the receivables (i.e. the customers of the assignor). Finally, the debtors of the receivables may be notified that their receivables have been factored

(“notification factoring”), or they may not be so notified (“non-notification factoring”). When notice is given to the customers, it is often accomplished by requiring the assignor to place a legend on the invoices that the assignor sends to its customers. The factor may also perform various services for the assignor in respect of the receivables, ranging from approving and evaluating the creditworthiness of the debtors of the receivables, performing bookkeeping duties and engaging in collection efforts with respect to receivables that are not paid when due. These services can provide a useful benefit to companies that do not have their own credit and collection departments.

63. Here is an illustration of a typical factoring arrangement: ABC enters into a discount factoring arrangement with Factor, pursuant to which Factor agrees to purchase receivables that Factor deems to be creditworthy. Factor advances to ABC an amount equal to 90 per cent of the face value of such receivables, holding the remaining 10 per cent as a reserve to cover potential customer claims and allowances that would reduce the value of the receivables. The factoring arrangement is with notification to ABC’s customers.

4. Securitization

64. Another highly effective form of financing involving the use of receivables is securitization. Securitization is a sophisticated form of financing under which a business enterprise can obtain less-expensive financing based on the value of its receivables by transferring them to a wholly owned “special purpose vehicle” (“SPV”) that will issue commercial paper or other securities in the capital markets secured by the stream of income generated by such receivables. For example, this technique is commonly used in situations where a company’s receivables consist of credit card receivables, rents or home mortgages, although the securitization of many other types of receivables is also possible. Securitization transactions are complex financing transactions that are also dependent upon a jurisdiction’s securities laws as well as its secured lending laws.

65. Securitization is intended to lower the cost of financing because the SPV is structured in a way to make the risk of its insolvency “remote” (e.g. theoretically not possible) by restricting the amount of debt that the SPV can incur. That significantly reduces one risk that the lender has to take into account when deciding what interest rate to charge for the loan. In addition, because the source of credit is the capital markets rather than the banking system, securitization can generate greater amounts of credit than bank loans and at lower costs than the normal bank loan costs.

66. Here is an illustration of a securitization transaction: An SPV is created by a subsidiary of an automobile manufacturer to purchase automobile leases from automobile dealers throughout a geographically defined market. The automobile leases are purchased from the dealers for a discount from the projected value of the payment streams expected to be generated by such leases. The SPV then issues debt securities, under applicable securities laws, to investors in the capital market secured by such income stream. As payments are made under the leases, the SPV will use such proceeds to make payments on the debt securities.

5. Term-loan financing

67. Businesses often need financing for large, non-ordinary-course expenditures, such as the acquisition of significant equipment or the acquisition of a business.

In these situations, businesses generally seek loans that are repayable over a fixed period of time (with principal being repaid in monthly, quarterly or other periodic instalments pursuant to an agreed-upon schedule or in a single payment at the end of the loan term).

68. As is the case with many other types of financing, a business that does not have strong, well-established credit ratings will have difficulty obtaining term-loan financing, unless the business is able to grant security rights in its assets to secure the financing. The amount of the financing will be based in part on the creditor's estimate of the net realizable value of the assets to be encumbered. In many States, immovable property is the only type of asset that typically is accepted by lenders to secure term-loan financing and, as a result, in such States term-loan financing is often not available for other important asset types, such as equipment or the enterprise value of an entire business. This is most likely the case in States that do not have a modern secured transactions regime. However, many businesses, in particular newly established businesses, do not own any immovable property and, therefore, may not have access to term-loan financing. In other States, term loans secured by movable property, such as equipment, intellectual property and the enterprise value of the business, are common.

69. Here is an illustration of this type of financing: ABC desires to expand its operations and purchase a business. ABC obtains a loan (predicated on the value of, and secured by, substantially all of the assets of the business being acquired) from Lender C to finance such acquisition. The loan is repayable in equal monthly instalments over a period of 10 years and is secured by existing and future assets of ABC and the entity being acquired.

6. Transfer of title for security purposes

70. In States that honour a form of transfer of ownership even when it does not entail a transfer of possession and is done for financing purposes, a transaction denominated as a transfer of title by way of security (or sometimes as a "fiduciary" transfer of title) is recognized. These transactions are essentially non-possessory security rights, and they are primarily used in States where the secured transactions law has not yet appropriately recognized non-possessory security rights.

7. Sale and leaseback transactions

71. A sale and leaseback transaction provides a method by which a company can obtain credit based upon its existing tangible property (usually equipment) while still retaining possession and the right to use the tangible property in the operation of its business. In a sale and leaseback transaction, the company will sell its assets to another person for a specific sum (which the company may then use as working capital, to make capital expenditures or for other purposes). Simultaneously with the sale, the company will lease the equipment back from that other person for a lease term and at a rental rate specified in the lease agreement. Often, the lease is a "financial lease" as opposed to an "operating lease" (see para. 27 above for a definition of both terms).

Recommendations 2-7 [Note to the Working Group: The Working Group may wish to note that recommendations 2-7 will be inserted here in the final version of the Guide.]

E. Note by the Secretariat on recommendations of the UNCITRAL draft Legislative Guide on Secured Transactions, submitted to the Working Group on Security Interests at its twelfth session

(A/CN.9/631 and Add.1-11) [Original: English]

A/CN.9/631

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[Note to the Commission: The Commission may wish to note that all the recommendations of the draft guide on secured transactions have been included in the present document (which is a revised version of document A/CN.9/WG.VI/WP.29) so as to assist the Commission in its consideration of the recommendations. Commentaries are included in addenda to this document. Once the Commission adopts the draft guide as a whole, the recommendations will be placed at the end of each chapter. The terminology of the draft guide, which was included in document A/CN.9/WG.VI/WP.29, will be included in part B of the introduction to the draft guide. As the term “secured transactions” may not be readily understood as referring to proprietary (as opposed to personal) security rights in movable property (as opposed to immovable property), the Commission may wish to include in the terminology a definition of the term “secured transactions” or name the draft guide the “UNCITRAL Legislative Guide on Proprietary Security Rights in Movable Property”.]

I. Key objectives of an effective and efficient secured transactions law

Purpose

The purpose of the recommendation on key objectives is to provide a broad policy framework for the establishment and development of an effective and efficient secured transactions law. This recommendation could be included in a preamble to the secured transactions law as a guide to the underlying legislative policies to be taken into account in the interpretation and the application of the secured transactions law (hereinafter referred to as “the law” or “this law”).

Key objectives

1. The law should be designed:
 - (a) To promote secured credit;
 - (b) To allow utilization of the full value inherent in a broad range of assets to support credit in the widest possible array of secured transactions;
 - (c) To enable parties to obtain security rights in a simple and efficient manner;
 - (d) To provide for equal treatment of diverse sources of credit and of diverse forms of secured transactions;
 - (e) To validate security rights in assets that remain in the possession of the grantor;
 - (f) To enhance predictability and transparency with respect to rights serving security purposes by providing for registration of a notice in a general security rights registry;
 - (g) To establish clear and predictable priority rules;
 - (h) To facilitate enforcement of creditor's rights in a predictable and efficient manner;
 - (i) To balance the interests of affected persons;
 - (j) To recognize party autonomy; and
 - (k) To harmonize secured transactions laws, including private international law rules.

II. Scope of application and other general rules**Purpose**

The purpose of the scope provisions of the law is to establish a single comprehensive regime for secured transactions. They specify the assets, the parties, the obligations and the security rights and other rights to which the law applies.

Assets, parties, obligations and security and other rights

2. Subject to recommendations 3-7, the law should apply to:
 - (a) All types of movable property and attachment, tangible or intangible, present or future, including inventory, equipment and other goods, contractual and non-contractual receivables, contractual non-monetary claims, negotiable instruments, negotiable documents, rights to payment of funds credited to a bank account, proceeds under an independent undertaking, and intellectual property;
 - (b) All legal and natural persons, including consumers, without, however, affecting their rights under consumer-protection legislation;
 - (c) All types of obligation, present or future, determined or determinable, including fluctuating obligations and obligations described in a generic way;
 - (d) All types of security right in movable property;
 - (e) All types of property right created contractually to secure the payment or other performance of an obligation, irrespective of the form of the relevant

transaction, including transfers of title to tangible property or assignments of receivables for security purposes, the various forms of retention-of-title sales, financial leases and hire-purchase agreements.

Outright transfers of receivables

3. The law should apply to outright transfers of receivables as provided in recommendation 162.

Aircraft, railway rolling stock, space objects, ships, intellectual property and securities

4. Notwithstanding recommendation 2, subparagraph (a), the law should not apply to:

(a) Aircraft, railway rolling stock, space objects, ships as well as other categories of mobile equipment, in so far as such property is covered by a national law or an international agreement to which the State enacting legislation based on these recommendations (hereinafter referred to as “the State” or “this State”) is a party and the matters covered by this law are addressed in that national law or international agreement;

(b) Intellectual property in so far as the provisions of this law are inconsistent with national law or international agreements, to which the State is a party, relating to intellectual property [and the matters covered by this law are addressed in that national law or international agreement]; and

[Note to the Commission: The Commission may wish to consider whether the bracketed text should be retained. It has been added to conform subparagraph (b) to subparagraph (a) and to ensure that no gap would be left if this law would not apply.]

(c) [Intermediated] securities [as defined in the International Institute for the Unification of Private Law (UNIDROIT) preliminary draft convention on substantive rules regarding intermediated securities, and securities traded on a regulated exchange].

[Note to the Commission: The Commission may wish to consider whether all securities should be excluded from the scope of the guide or just intermediated securities as defined in the UNIDROIT preliminary draft convention on substantive rules regarding intermediated securities (as adopted by the Committee of Governmental Experts at its third session, held in Rome, 6-15 November 2006).]

Under this UNIDROIT draft convention, the term “securities” “means any shares, bonds or other financial instruments or financial assets (other than cash), which are capable of being credited to a securities account and of being acquired and disposed of in accordance with the provisions of this Convention”. Under the same draft convention the term “intermediated securities” “means securities credited to a securities account or rights or interests in securities resulting from the credit of securities to a securities account”.

If the Commission were to exclude all securities, no guidance would be given to States with respect to security rights in securities other than intermediated securities. In particular, no guidance would be given with respect to important financing practices in which privately held securities that are not traded in any capital market and are not intermediated securities are used as security for credit.

If the Commission were to decide to exclude only intermediated securities, it may wish to consider appropriate adjustments to certain recommendations of the draft guide in order for the draft guide to apply to such securities.]

Immovable property

5. The law should provide that, although it may affect immovable property, as provided in recommendations 26 and 49, it does not apply to immovable property.

Proceeds of excluded types of asset

6. The law should provide that law other than this law determines whether a security right in excluded types of property (e.g. immovable property) confers a security right in types of proceeds to which the law applies (e.g. receivables). If, under that other law, there is a security right in types of proceeds to which the law applies, the law applies to that security right except to the extent that that other law applies to [the third-party effectiveness, priority or enforcement of that security right] [that security right].

Other exceptions

7. The law should limit any other exceptions to its scope of application and, to the extent any other exceptions are made, they should be set out in the law in a clear and specific way.

Party autonomy

8. The law should provide that, except as otherwise provided in recommendations 14, 109, 129-132, 202-211 and 213-222, the secured creditor and the grantor or the debtor may derogate from or vary by agreement its provisions relating to their respective rights and obligations. Such an agreement does not affect the rights of any person that is not a party to the agreement.

Electronic communications

9. The law should provide that, where it requires that a communication or a contract should be in writing, or provides consequences for the absence of a writing, that requirement is met by an electronic communication if the information contained therein is accessible so as to be usable for subsequent reference.

10. The law should provide that, where the law requires that a communication or a contract should be signed by a person, or provides consequences for the absence of a signature, that requirement is met in relation to an electronic communication if:

(a) A method is used to identify the party and to indicate that person's intention in respect of the information contained in the electronic communication; and

(b) The method used is either:

(i) As reliable as appropriate for the purpose for which the electronic communication was generated or communicated, in the light of all the circumstances, including any relevant agreement; or

(ii) Proven in fact to have fulfilled the functions described in subparagraph (a) above, by itself or together with further evidence.

[Note to the Commission: The Commission may wish to note that recommendations 9 and 10 are based on article 9, paragraphs 2 and 3, of the United Nations Convention on the Use of Electronic Communications in International Contracts.]

III. Basic approaches to security

Purpose

The purpose of the recommendations on basic approaches to security is to ensure that the law covers in an integrated and consistent manner all forms of rights in movable property that serve security purposes.

Integrated and functional approach

11. The law should establish an integrated and consistent set of provisions on security rights in tangible and intangible property. Its provisions should apply to all contractually created rights (regardless of form) in movable property that secure an obligation, including rights under a transfer of title to tangible property or an assignment of receivables for security purposes, the various forms of a retention-of-title sale, a financial lease or a hire-purchase agreement. [The provisions of the law apply to security rights that are extended in proceeds by operation of this law. The priority provisions of the law apply to rights arising by operation of law (e.g. preferential claims) or from a court judgement.]

[Note to the Commission: The Commission may wish to consider whether the text in square brackets should be retained. It is intended to clarify that the law may have an impact on rights that are not created contractually.]

IV. Creation of a security right (effectiveness as between the parties)

Purpose

The purpose of the provisions of the law dealing with creation is to specify the way in which a security right in movable property is created (i.e. becomes effective as between the parties).

A. General recommendations

Creation of a security right

12. The law should provide that a security right in movable property is created by an agreement concluded between the grantor and the secured creditor. In the case of property with respect to which the grantor has rights or the power to encumber at the time of the conclusion of the agreement, the security right in that property is created at that time. In the case of property with respect to which the grantor acquires rights or the power to encumber thereafter, the security right in that asset is created when the grantor acquires rights in the property or the power to encumber the property.

Essential elements of a security agreement

13. The law should provide that, for a security agreement to be effective, it must reflect the intent of the parties to create a security right, identify the secured creditor and the grantor, and describe the secured obligation and the encumbered assets. A generic description of the encumbered assets is sufficient (e.g. “all present and future assets” or “all present and future inventory”).

Form of the security agreement

14. The law should provide that a security agreement may be oral if accompanied by transfer of possession of the encumbered asset. Otherwise, the agreement must be concluded in or evidenced by a writing that in conjunction with the course of conduct between the parties indicates the grantor’s intent to create a security right.

Obligations subject to a security agreement

15. The law should provide that a security right may secure any type of obligation, present or future, determined or determinable, as well as conditional and fluctuating obligations.

Assets subject to a security agreement

16. The law should provide that a security agreement may cover any type of asset, including parts of assets and undivided interests in assets. A security agreement may cover assets that, at the time the security agreement is concluded, may not yet exist or that the grantor may not yet own or have the power to encumber. It may also cover all assets of a grantor. Any exceptions to these rules should be limited and described in the law in a clear and specific way.

17. The law should provide that, except as provided in recommendations 24-26, it does not override provisions of any other law to the extent that they limit the creation or enforcement of a security right in, or the transferability of, specific types of asset.

Creation of a security right in proceeds

18. The law should provide that, unless otherwise agreed by the parties to the security agreement, the security right in the encumbered asset extends to its identifiable proceeds.

Commingled proceeds

19. The law should provide that, where proceeds in the form of money or funds credited to a bank account have been commingled with other property of the same kind so that the proceeds are no longer identifiable, the amount of the proceeds immediately before they were commingled is to be treated as identifiable proceeds after commingling. However, if, at any time after commingling, the total amount of the property is less than the amount of the proceeds, the total amount of the property at the time that its amount is lowest plus the amount of any proceeds later commingled with the property is to be treated as identifiable proceeds.

20. The law should provide that, where proceeds other than money or funds credited to a bank account have been commingled with other property of the same kind so that the proceeds are not identifiable, the share of the total property that the

value of the proceeds bears to the total value of the property, is to be treated as identifiable proceeds.

Tangible property commingled in a mass or product

21. The law should provide that recommendations 19 and 20 apply also to items of tangible property commingled in a mass or product.

Creation of a security right in an attachment

22. The law should provide that a security right may be created in tangible property that is an attachment at the time of creation of the security right or continues in tangible property that becomes an attachment subsequently. A security right in an attachment to immovable property may be created under this law or under the law governing immovable property.

Creation of a security right in a mass or product

23. The law should provide that a security right may not be created in items of tangible property that are commingled in a mass or product. However, a security right created in items of tangible property before they are commingled in a mass or product continues in the mass or product. The security right that continues in the mass or product is limited to the value of the items immediately before they become part of the mass or product.

B. Asset-specific recommendations

[Note to the Commission: The Commission may wish to note that recommendations 24-26 are based on articles 8-10 of the United Nations Convention on the Assignment of Receivables in International Trade (hereinafter referred to as "the United Nations Assignment Convention").]

Effectiveness of a bulk assignment of receivables and an assignment of future, parts of and undivided interests in receivables

24. The law should provide that:

(a) An assignment of contractual receivables that are not specifically identified, future receivables and parts of or undivided interests in receivables is effective as between the assignor and the assignee and as against the debtor of the receivable, as long as, at the time of the assignment or, in the case of future receivables, at the time they arise, they can be identified to the assignment to which they relate; and

(b) Unless otherwise agreed, an assignment of one or more future receivables is effective without a new act of transfer being required to assign each receivable.

Effectiveness of an assignment of receivables made despite an anti-assignment clause

25. The law should provide that:

(a) An assignment of a receivable is effective as between the assignor and the assignee and as against the debtor of the receivable notwithstanding an

agreement between the initial or any subsequent assignor and the debtor of the receivable or any subsequent assignee limiting in any way the assignor's right to assign its receivables;

(b) Nothing in this recommendation affects any obligation or liability of the assignor for breach of the agreement mentioned in subparagraph (a) of this recommendation, but the other party to such an agreement may not avoid the original contract or the assignment contract on the sole ground of that breach. A person that is not a party to such an agreement is not liable on the sole ground that it had knowledge of the agreement;

(c) This recommendation applies only to assignments of receivables:

(i) Arising from an original contract that is a contract for the supply or lease of goods or services other than financial services, a construction contract or a contract for the sale or lease of immovable property;

(ii) Arising from an original contract for the sale, lease or licence of industrial or other intellectual property or of proprietary information;

(iii) Representing the payment obligation for a credit card transaction;

(iv) Owed to the assignor upon net settlement of payments due pursuant to a netting agreement involving more than two parties.

Creation of a security right in a personal or property right securing a receivable, a negotiable instrument or any other obligation

26. The law should provide that:

(a) A secured creditor with a security right in a receivable, negotiable instrument or any other intangible asset covered by this law has the benefit of any personal or property right that secures payment or other performance of the receivable, negotiable instrument or other obligation automatically, without further action by either the grantor or the secured creditor;

(b) If the personal or property right is an independent undertaking, the security right automatically extends to the proceeds under the independent undertaking but does not extend to the right to draw under the independent undertaking;

(c) This recommendation does not affect a right in immovable property that under law other than this law is transferable separately from a receivable, negotiable instrument or other obligation that it may secure;

(d) A secured creditor with a security right in a receivable, negotiable instrument or any other intangible asset covered by this law has the benefit of any personal or property right securing payment or other performance of the receivable, negotiable instrument or other obligation notwithstanding any agreement between the grantor and the debtor of the receivable or the obligor of the negotiable instrument or other obligation limiting in any way the grantor's right to create a security right in the receivable, negotiable instrument or other obligation, or in any personal or property right securing payment or other performance of the receivable, negotiable instrument or other obligation;

(e) Nothing in this recommendation affects any obligation or liability of the grantor for breach of the agreement mentioned in subparagraph (d) of this recommendation, but the other party to such an agreement may not avoid the contract from which the receivable, negotiable instrument or other obligation arises,

or the security agreement creating the personal or property security right on the sole ground of that breach. A person that is not a party to such an agreement is not liable on the sole ground that it had knowledge of the agreement;

(f) Subparagraphs (d) and (e) of this recommendation apply only to security rights in receivables, negotiable instruments or other obligations:

(i) Arising from an original contract that is a contract for the supply or lease of goods or services other than financial services, a construction contract or a contract for the sale or lease of immovable property;

(ii) Arising from an original contract for the sale, lease or licence of industrial or other intellectual property or of proprietary information;

(iii) Representing the payment obligation for a credit card transaction;

(iv) Owed to the assignor upon net settlement of payments due pursuant to a netting agreement involving more than two parties;

(g) Subparagraph (a) of this recommendation does not affect any duties of the grantor to the debtor of the receivable or to the obligor of the negotiable instrument or other obligation;

(h) To the extent that the automatic effects under subparagraph (a) of this recommendation and recommendation 49 are not impaired, this recommendation does not affect any requirement under law other than this law relating to the form or registration of the creation of a security right in any asset, securing payment or other performance of a receivable, negotiable instrument or other obligation, that is not covered by this law.

Creation of a security right in a right to payment of funds credited to a bank account

27. The law should provide that a security right in a right to payment of funds credited to a bank account is effective notwithstanding an agreement between the grantor and the depositary bank limiting in any way the grantor's right to create such a security right. However, the depositary bank has no duty to recognize the secured creditor and no obligation is otherwise imposed on the depositary bank with respect to the security right without the depositary bank's consent (for the depositary bank's rights and obligations, see recommendations 122 and 123).

Creation of a security right in proceeds under an independent undertaking

28. The law should provide that a beneficiary may grant a security right in proceeds under an independent undertaking, even if the right to draw under the independent undertaking is itself not transferable under law and practice governing independent undertakings. The creation of a security right in proceeds under an independent undertaking is not a transfer of the right to draw under an independent undertaking.

Creation of a security right in a negotiable document or goods covered by a negotiable document

29. The law should provide that a security right in a negotiable document extends to the goods covered by the document, provided that the issuer is in possession of the goods, directly or indirectly, at the time the security right in the document is created.

V. Effectiveness of a security right against third parties

Purpose

The purpose of the requirements of the law for the effectiveness of a security right against third parties is to create a foundation for the predictable, fair and efficient ordering of priority by:

(a) Requiring registration as a precondition for the effectiveness of a security right against third parties, except where exceptions and alternatives to registration are appropriate in light of countervailing commercial policy considerations; and

(b) Establishing a legal framework to create and support a simple, cost-efficient and effective public registry system for the registration of notices with respect to security rights.

A. General recommendations

Meaning of third-party effectiveness

30. The law should provide that a security right is effective against third parties only if it is created in accordance with this law and one of the methods referred to in recommendation 33, 35 or 36 has been followed.

Effectiveness against the grantor of a security right that is not effective against third parties

31. The law should provide that a security right that has been created in accordance with the provisions of the law on creation is effective between the grantor and the secured creditor even if it is not effective against third parties.

Continued third-party effectiveness of a security right after a transfer of the encumbered asset

32. The law should provide that, after transfer of a right other than a security right in an encumbered asset, a security right in the encumbered asset that is effective against third parties at the time of the transfer continues to encumber the asset except as provided in recommendations 85-87, and remains effective against third parties except as provided in recommendation 62.

[Note to the Commission: The Commission may wish to note that recommendations 33-37 are not intended to state the relevant rules but rather to list, for the ease of the reader, the various methods for achieving third-party effectiveness and to refer to the following recommendations that state the relevant rules.]

General method for achieving third-party effectiveness of a security right

33. The law should provide that a security right created in accordance with the provisions of the law on creation is effective against third parties if a notice with respect to the security right is registered in the general security rights registry referred to in recommendations 55-73.

34. The law should provide that registration of a notice does not create a security right and is not necessary for the creation of a security right.

Alternatives and exceptions to registration for achieving third-party effectiveness of a security right

35. The law should provide that:

(a) A security right may also be made effective against third parties by one of the following alternative methods:

(i) In tangible property, by transfer of possession, as provided in recommendation 38;

(ii) In goods covered by a negotiable document, by transfer of possession of the document, as provided in recommendations 52-54;

(iii) In movable property subject to registration in a specialized registry or notation on a title certificate, by such registration or notation, as provided in recommendation 39;

(iv) In a right to payment of funds credited to a bank account, by control, as provided in recommendation 50; and

(v) In an attachment to immovable property, by registration in the general security rights registry or in the immovable property registry, as provided in recommendation 43;

(b) A security right is effective against third parties automatically:

(i) In proceeds, if the security right in the original encumbered assets is effective against third parties, as provided in recommendations 40 and 41;

(ii) In an attachment to movable property, if the security right in the separate movable property is effective against third parties before it becomes an attachment, as provided in recommendation 42;

(iii) In a mass or product, if the security right in the separate movable property is effective against third parties before it becomes part of the mass or product, as provided in recommendation 45; and

(iv) In movable property, upon a change in the location of the property or the grantor to this State, as provided in recommendation 46; and

(c) A security right in a personal or property right securing payment or other performance of a receivable, negotiable instrument or other obligation is effective against third parties, as provided in recommendation 49.

Exclusive method for achieving third-party effectiveness of a security right in proceeds under an independent undertaking

36. The law should provide that, except as provided in recommendation 49, a security right in proceeds under an independent undertaking is made effective against third parties only by control, as provided in recommendation 51.

Different third-party effectiveness methods for different types of asset

37. The law should provide that different methods for achieving third-party effectiveness may be used for different types of encumbered asset, whether they are encumbered pursuant to the same security agreement or not.

Third-party effectiveness of a security right in tangible property by possession

38. The law should provide that a security right in tangible property may be made effective against third parties by registration as provided in recommendation 33 or through transfer of possession to the secured creditor.

Third-party effectiveness of a security right in movable property with respect to which there is a specialized registration or a title certificate system

39. The law should provide that a security right in movable property that is subject to registration in a specialized registry or notation on a title certificate under law other than this law may be made effective against third parties by registration as provided in recommendation 33 or by:

- (a) Registration in the specialized registry; or
- (b) Notation on the title certificate.

Automatic third-party effectiveness of a security right in proceeds

40. The law should provide that, if a security right in an encumbered asset is effective against third parties, a security right in any proceeds of the encumbered asset (including any proceeds of proceeds) is effective against third parties when the proceeds arise, provided that the proceeds are described in a generic way in a registered notice or that the proceeds consist of money, receivables, negotiable instruments or rights to payment of funds credited to a bank account.

41. If recommendation 40 does not apply, the security right in the proceeds is effective against third parties for [to be specified] days after the proceeds arise and continuously thereafter, if it was made effective against third parties by one of the methods referred to in recommendation 33 or 35 before the expiry of that time period.

Automatic third-party effectiveness of a security right in an attachment

42. The law should provide that, if a security right in tangible property is effective against third parties at the time when the tangible property becomes an attachment, the security right remains effective against third parties thereafter.

Third-party effectiveness of a security right in an attachment with respect to which there is a specialized registration or a title certificate system

43. The law should provide that a security right in an attachment to movable property that is subject to registration in a specialized registry or notation on a title certificate under law other than this law may be made effective against third parties automatically as provided in recommendation 42 or by:

- (a) Registration in the specialized registry; or
- (b) Notation on the title certificate.

44. The law should provide that a security right in an attachment to immovable property may be made effective against third parties automatically as provided in recommendation 42 or by registration in the immovable property registry.

Automatic third-party effectiveness of a security right in a mass or product

45. The law should provide that, if a security right in tangible property is effective against third parties when it becomes part of a mass or product, the security right that continues in the mass or product, as provided in recommendation 23, is effective against third parties.

Continuity in third-party effectiveness of a security right upon change of location

46. The law should provide that, if a security right in an encumbered asset is effective against third parties under the law of the State in which the encumbered asset or the grantor (as may be the case) is located and that location changes to this State, the security right continues to be effective against third parties under the law of this State for a period of [to be specified] days after the location of the encumbered asset or the grantor has changed to this State. If the requirements of the law of this State to make the security right effective against third parties are satisfied prior to the end of that period, the security right continues to be effective against third parties thereafter under the law of this State. For the purposes of any rule of this State in which time of registration or other method of achieving third-party effectiveness is relevant for determining priority, that time is the time when that event occurred under the law of the State in which the encumbered assets or the grantor were located before their location changed to this State.

Continuity in third-party effectiveness of a security right upon change of method of third-party effectiveness

47. The law should provide that third-party effectiveness of a security right is continuous notwithstanding a change in the method by which it is made effective against third parties, provided that there is no time when the security right is not effective against third parties.

Lapse in third-party effectiveness or advance registration of a security right

48. The law should provide that, if a security right has been made effective against third parties and subsequently there is a period during which the security right is not effective against third parties, third-party effectiveness may be re-established. In such a case, third-party effectiveness takes effect from the time thereafter when the security right is made effective against third parties. Similarly, if registration made before creation of a security right as provided in recommendation 65 expires as provided in recommendation 67, it may be re-established. In such a case, registration takes effect from the time thereafter when a notice with respect to the security right is registered.

B. Asset-specific recommendations**Third-party effectiveness of a security right in a personal or property right securing payment of a receivable, negotiable instrument or any other obligation**

49. The law should provide that, if a security right in a receivable, negotiable instrument or any other intangible asset covered by this law is effective against third parties, such third-party effectiveness extends to any personal or property right that secures payment or other performance of the receivable, negotiable instrument

or other obligation, without further action by either the grantor or the secured creditor. If the personal or property right is an independent undertaking, its third-party effectiveness automatically extends to the proceeds under the independent undertaking (but, as provided in recommendation 26, subparagraph (b), the security right does not extend to the right to draw under the independent undertaking). This recommendation does not affect a right in immovable property that under law other than this law is transferable separately from a receivable, negotiable instrument or other obligation that it may secure.

Third-party effectiveness of a security right in a right to payment of funds credited to a bank account

50. The law should provide that a security right in a right to payment of funds credited to a bank account may be made effective against third parties by registration as provided in recommendation 33 or by the secured creditor obtaining control with respect to the right to payment of funds credited to the bank account.

Third-party effectiveness of a security right in proceeds under an independent undertaking

51. The law should provide that, except as provided in recommendation 49, a security right in proceeds under an independent undertaking may be made effective against third parties only by the secured creditor obtaining control with respect to the proceeds under the independent undertaking.

Third-party effectiveness of a security right in a negotiable document or goods covered by a negotiable document

52. The law should provide that a security right in a negotiable document may be made effective against third parties by registration as provided in recommendation 33 or by the secured creditor obtaining possession of the document.

53. The law should provide that, if a security right in a negotiable document is effective against third parties, the corresponding security right in the goods covered by the document is also effective against third parties. As long as a negotiable document covers goods, a security right in the goods may be made effective against third parties by the secured creditor obtaining possession of the document.

54. The law should provide that a security right in a negotiable document that was made effective against third parties by the secured creditor obtaining possession of the document remains effective against third parties for a short period of [to be specified] days after the negotiable document has been relinquished to the grantor or other person for the purpose of ultimate sale or exchange, loading or unloading, or otherwise dealing with the goods covered by the negotiable document.

VI. The registry system

Purpose

The purpose of the provisions of the law on the registry system is to establish a general security rights registry and to regulate its operation. The purpose of the registry system is to provide:

(a) A method by which an existing or future security right in a grantor's existing or future assets may be made effective against third parties;

(b) An efficient point of reference for priority rules based on the time of registration of a notice with respect to a security right; and

(c) An objective source of information for third parties dealing with a grantor's assets (such as prospective secured creditors and buyers, judgement creditors and the grantor's insolvency representative) as to whether the assets may be encumbered by a security right.

To achieve this purpose, the registry system should be designed to ensure that the registration and searching processes are simple, time- and cost-efficient, user-friendly and publicly accessible.

Operational framework of the registration and searching processes

55. The law should provide a framework to ensure that the registration and searching processes operate as follows:

(a) Clear and concise guides to registration and searching procedures are widely available and information about the existence and role of the registry is widely disseminated;

(b) Registration is effected by registering a notice that provides the information specified in recommendation 58, as opposed to requiring the submission of the original or a copy of the security agreement or other document;

(c) The registry must accept a notice presented by an authorized medium of communication (e.g. paper, electronic) except if:

(i) It is not accompanied by the required fee;

(ii) It fails to provide a grantor identifier sufficient to allow indexing; or

(iii) It fails to provide some information with respect to any of the other items required under recommendation 58;

(d) The registrar may not require verification of the identity of the registrant or the existence of authorization for registration of the notice or conduct further scrutiny of the content of the notice;

(e) The record of the registry is centralized and contains all notices of security rights registered under this law;

(f) The information provided on the record of the registry is available to the public;

(g) A search may be made without the need for the searcher to justify the reasons for the search;

(h) Notices are indexed and can be retrieved by searchers according to the name of the grantor or according to some other reliable identifier of the grantor;

(i) Fees for registration and for searching, if any, are set at a level no higher than necessary to permit cost recovery;

(j) Registrants may choose among multiple modes and points of access to the registry;

(k) The registry, to the extent it is electronic, operates continuously except for scheduled maintenance, and, to the extent it is not electronic, operates during

reliable and consistent service hours compatible with the needs of potential registry users; and

- (l) If possible, the registration system is electronic. In particular,
 - (i) Notices are stored in electronic form in a computer database;
 - (ii) Registrants and searchers have immediate access to the registry record by electronic or similar means, including internet and electronic data interchange;
 - (iii) The system is programmed to minimize the risk of entry of incomplete or irrelevant information; and
 - (iv) The system is programmed to facilitate speedy and complete retrieval of information and to minimize the practical consequences of human error.

Security and integrity of the registry

56. In order to ensure the security and integrity of the registry, the law should provide that the operational and legal framework of the registry should reflect the following characteristics:

- (a) Although the day-to-day operation of the registry may be delegated to a private authority, the State retains the responsibility to ensure that it is operated in accordance with the governing legal framework;
- (b) The identity of a registrant is requested and maintained by the registry (as to verification of the registrant's identity, see recommendation 55, subparagraph (d));
- (c) The registrant is obligated to forward a copy of a notice to the grantor named in the notice. Failure of the secured creditor to meet this obligation may result only in nominal penalties and any damages resulting from the failure that may be proven;
- (d) The registry is obligated to send promptly a copy of any changes to a registered notice to the person identified as the secured creditor in the notice;
- (e) A registrant can obtain a record of the registration as soon as the registration information is entered into the registry record; and
- (f) Multiple copies of all the information in the records of a registry are maintained and the entirety of the registry records can be reconstructed in the event of loss or damage.

Responsibility for loss or damage

57. The law should provide for the allocation of responsibility for loss or damage caused by an error in the administration or operation of the registration and searching system. If the system is designed to permit direct registration and searching by registry users without the intervention of registry personnel, the responsibility of the registry should be limited to a system malfunction.

Required content of notice

58. The law should provide that only the following information is required to be provided in the notice:

(a) The identifier of the grantor, satisfying the standard provided in recommendations 59-61, and the secured creditor or its representative and their addresses;

(b) A description of the asset covered by the notice, satisfying the standard provided in recommendation 64;

(c) The duration of the registration as provided in recommendation 67; and

(d) If the State determines that the maximum monetary amount for which the security right may be enforced is helpful to facilitate subordinate lending, a statement of that maximum amount.

Sufficiency of grantor identifier

59. The law should provide that a notice is effective only if it states the grantor's correct identifier or, in the case of an incorrect statement, if the notice would be retrieved by a search of the registry record under the correct identifier.

60. The law should provide that, where the grantor is a natural person, the identifier of the grantor for the purposes of effective registration is the grantor's name, as it appears in a specified official document. Where necessary, additional information, such as the birth date or identity card number, should be required to uniquely identify the grantor.

61. The law should provide that, where the grantor is a legal person, the grantor's identifier for the purposes of effective registration is the name that appears in the documents constituting the legal person.

Impact of a change of the grantor's identifier on the effectiveness of the registration

62. The law should provide that, if, after a notice is registered, the identifier of the grantor used in the notice changes and as a result the grantor's identifier does not meet the standard provided in recommendations 59-61, the secured creditor may amend the registered notice to provide the new identifier in compliance with that standard. If the secured creditor does not register the amendment within [to be specified] days after the change, the security right is ineffective against:

(a) A competing security right with respect to which a notice is registered or which is otherwise made effective against third parties before the registration of such an amendment; and

(b) A person that buys [, leases or licenses] the encumbered asset before the registration of such an amendment.

Impact of a transfer of an encumbered asset on the effectiveness of the registration

63. The law should provide that, if, after a notice is registered, the grantor transfers the encumbered asset, the secured creditor has [to be specified] days to amend the registered notice to provide the identifier of the transferee. If the secured

creditor does not register the amendment within [to be specified] days after the transfer, the security right is ineffective against:

(a) A competing security right with respect to which a notice is registered or which is otherwise made effective against third parties before the registration of such an amendment; and

(b) A person that buys [, leases or licenses] the encumbered asset before the registration of such an amendment.

Sufficiency of description of assets covered by a notice

64. The law should provide that a description of the assets covered by a notice is sufficient if it reasonably describes the assets covered by the notice. A generic description of the encumbered assets, as provided in recommendation 13, is sufficient.

Time of registration

65. The law should provide that a notice with respect to a security right may be registered before or after creation of the security right, or conclusion of the security agreement.

One notice sufficient for multiple security rights arising from multiple agreements between the same parties

66. The law should provide that registration of a single notice is sufficient to achieve third-party effectiveness of more than one security right arising from more than one security agreement between the same parties, whether the security rights exist at the time of registration or are created only thereafter.

Duration and extension of the registration of a notice

67. The law should either specify the duration of the effectiveness of the registration of a notice or permit the registrant to specify the duration in the notice at the time of registration and extend it at any time before its expiry. In either case, the secured creditor should be entitled to extend the period of effectiveness by submitting a notice of amendment to the registry at any time before the expiry of the effectiveness of the notice. If the law specifies the time of effectiveness of the registration, the extension period resulting from the registration of the notice of amendment should be an additional period equal to the initial period. If the law permits the registrant to specify the duration of the effectiveness of the registration, the extension period should be that specified in the notice of amendment.

Time of effectiveness of registration of a notice or amendment

68. The law should provide that registration of a notice or an amendment becomes effective when the information contained in the notice or the amendment is entered into the registry records so as to be available to searchers of the registry record.

Authority for registration

69. The law should provide that registration of a notice is ineffective unless authorized by the grantor in writing. The authorization may be given before or after registration. A written security agreement is sufficient to constitute authorization for

the registration. The effectiveness of registration does not depend on the identity of the registrant.

Cancellation or amendment of notice

70. The law should provide that, if no security agreement has been concluded, the security right has been extinguished by full payment or otherwise, or a registered notice is not authorized by the grantor:

(a) The secured creditor is obliged to submit to the registry a notice of cancellation or amendment, to the extent appropriate, with respect to the relevant registered notice not later than [to be specified] days after the secured creditor's receipt of the written request of the grantor;

(b) The grantor is entitled to seek cancellation or appropriate amendment of the notice through a summary judicial or administrative procedure;

(c) The grantor is entitled to seek cancellation or appropriate amendment of the notice, as provided in subparagraph (b), even before the expiry of the period provided in subparagraph (a), provided that there are appropriate mechanisms to protect the secured creditor.

[Note to the Commission: The Commission may wish to add a recommendation addressing the right of the secured creditor to amend the notice, for example to change its address or name, or the description of the encumbered asset.]

71. The law should provide that the secured creditor is entitled to submit to the registry a notice of cancellation or amendment, to the extent appropriate, with respect to the relevant registered notice at any time.

72. The law should provide that promptly after a registered notice has expired as provided in recommendation 67 or has been cancelled as provided in recommendation 70 or 71, the information contained in the notice should be removed from the records of the registry, which are accessible to the public. However, the information provided in the expired or cancelled or amended notice and the fact of expiration or cancellation or amendment should be archived so as to be capable of retrieval if necessary.

73. The law should provide that, in the case of an assignment of the secured obligation, the notice may be amended to indicate the name of the new secured creditor but the unamended notice remains effective.

VII. Priority of a security right as against the rights of competing claimants

Purpose

The purpose of the provisions of the law on priority is:

(a) To provide an efficient and predictable regime to determine the priority of a security right as against the rights of competing claimants; and

(b) To facilitate transactions by which a grantor may create more than one security right in the same asset and thereby use the full value of its assets to obtain credit.

A. General recommendations

Extent of priority

74. The law should provide that the priority of a security right extends to all obligations secured under the security agreement. If the security right is made effective against third parties by registration and the notice registered sets out the maximum monetary amount secured if required pursuant to recommendation 58, subparagraph (d), the priority of the security right extends to all secured obligations up to that maximum amount.

Irrelevance of knowledge of the existence of the security right

75. The law should provide that knowledge of the existence of a security right on the part of a competing claimant does not affect its rights under the provisions of the law on priority (as for the impact of knowledge that a transaction violates the rights of a secured creditor, see recommendations 87, 100, subparagraph (b), 103 and 104).

Priority of security rights securing future obligations

76. The law should provide that, subject to recommendation 90, the priority of a security right does not depend on the time when the secured obligation was incurred.

Subordination

77. The law should provide that a competing claimant entitled to priority may at any time subordinate its priority unilaterally or by agreement in favour of any other existing or future competing claimant.

Priority between security rights in the same encumbered assets

78. The law should provide that, except as provided in recommendations 83, 84, 93-107, 189-195, 198 and 199, priority between competing security rights in the same encumbered assets is determined as follows, based on the earliest time when it may be asserted:

(a) As between security rights that were made effective against third parties by registration of a notice, priority is determined by the order of registration, regardless of the order of creation of the security rights;

(b) As between security rights that were made effective against third parties otherwise than by registration, priority is determined by the order of third-party effectiveness;

(c) As between a security right that was made effective against third parties by registration and a security right that was made effective against third parties otherwise than by registration, priority is determined by the order of registration (regardless of when creation occurs) and third-party effectiveness [whichever occurs first].

Priority of a security right in after-acquired property

79. The law should provide that, if the priority of a security right is determined by the time of the registration of a notice, the time of registration determines the priority of a security right with respect to all encumbered assets irrespective of

whether they are acquired by the grantor or come into existence before, on or after the time of registration.

Priority of a security right in proceeds

80. The law should provide that, for purposes of recommendation 78, the time of registration or third-party effectiveness as to a security right in an encumbered asset is also the time of registration or third-party effectiveness of a security right in proceeds.

Continuity in priority

81. The law should provide that the priority of a security right is not affected by a change in the method by which it is made effective against third parties, provided that there is no time when the security right is not effective against third parties.

82. The law should provide that, if a security right has been registered or made effective against third parties and subsequently there is a period during which the security right is neither registered nor effective against third parties, the priority of that security right dates from the earliest time thereafter when the security right is either registered or made effective against third parties.

Priority of a security or other right registered in a specialized registry or noted on a title certificate

[Note to the Commission: The Commission may wish to note that the priority rules in recommendations 83 and 84 apply unless the specialized registration regime has different priority rules.]

83. The law should provide that a security right in an asset that is made effective against third parties by registration in a specialized registry or notation on a title certificate, as provided in recommendation 39, has priority as against:

(a) A security right in the same asset with respect to which a notice is registered in the general security rights registry or which is made effective against third parties by a method other than registration in a specialized registry or notation on a title certificate regardless of the order; and

(b) A security right that is subsequently registered in the specialized registry or noted on a title certificate.

84. [The law should provide that, if a security right in an encumbered asset is transferred and the security right in that asset is made effective against third parties by registration in a specialized registry or notation on a title certificate as provided in recommendation 39 before the transfer, the transferee takes its rights subject to the security right except as provided in recommendations 86-88. However, if the security right has not been made effective against third parties by registration in a specialized registry or notation on a title certificate, a buyer, lessee or licensee takes its rights free of the security right.]

[Note to the Commission: The Commission may wish to note that recommendation 84, which tracks the language of recommendation 85, has been added to deal with a conflict between a security right made effective against third parties by registration in a specialized registry or notation on a title certificate and a transferee of the encumbered asset. It provides that: a transferee takes its rights subject to the security right except as provided in recommendations 86-88; and a transferee for value (i.e. a buyer, lessee or licensee) takes its rights free of the

security right if it was not effective against third parties. The Commission may wish to consider whether recommendation 85 is sufficient to reflect this rule, in which case recommendation 84 could be deleted.]

Rights of buyers, lessees and licensees of an encumbered asset

85. The law should provide that, if a right in an encumbered asset is transferred and the security right in that asset is effective against third parties at the time of the transfer, a transferee takes its rights subject to the security right except as provided in recommendations 86-88.

86. The law should provide that:

(a) A security right does not continue in an encumbered asset that the grantor sells or otherwise disposes of, if the secured creditor authorizes the sale or other disposition free of the security right; and

(b) The rights of a lessee or licensee of an encumbered asset are not affected by a security right if:

(i) The secured creditor authorizes the grantor to lease or license the asset unaffected by the security right; or

(ii) In the case of a security right registered before creation, the secured creditor has knowledge of the lease or licence.

[Note to the Commission: The Commission may wish to consider whether subparagraph (b)(ii) should be deleted. If a security right is registered before it is created, it is not effective against third parties and no issue of priority arises. Thus, whether the secured creditor has knowledge of the lease or license is irrelevant.]

87. The law should provide that:

(a) A buyer of inventory or consumer goods in the ordinary course of the seller's business that does not have knowledge that the sale violates the rights of a secured creditor under a security agreement takes free of the security right;

(b) The rights of a person that accepts a lease of inventory in the lessor's ordinary course of business without knowledge that the lease violates the rights of a secured creditor under a security agreement are not affected by the security right; and

(c) The rights of a person that accepts non-exclusive licence of intangible property in the licensor's ordinary course of business without knowledge that the licence violates the rights of a secured creditor under a security agreement are not affected by the security right.

88. The law should provide that, where a buyer acquires a right in an encumbered asset free of a security right, any person that subsequently acquires a right in that asset from that buyer also takes free of the security right. Where the rights of a lessee or licensee are not affected by a security right, the rights of a sublessee or sublicensee are also unaffected by the security right.

Priority of preferential claims

89. The law should limit, both in number and amount, preferential claims arising by operation of law that have priority as against security rights and, to the extent preferential claims exist, they should be described in the law in a clear and specific way.

Priority of rights of judgement creditors

90. The law should provide that, except as provided in recommendation 194, a security right has priority as against the rights of an unsecured creditor, unless the unsecured creditor, under law other than this law, obtained a judgement or provisional court order against the grantor and took the steps necessary to acquire rights in assets of the grantor by reason of the judgement or provisional court order before the security right was made effective against third parties. The priority of the security right extends to credit extended by the secured creditor:

(a) Before the expiry of [to be specified] days after the unsecured creditor notified the secured creditor that it had taken steps necessary to acquire rights in the encumbered asset; or

(b) Pursuant to an irrevocable commitment (in a fixed amount or an amount to be fixed pursuant to a specified formula) of the secured creditor to extend credit, if the commitment was made before the unsecured creditor notified the secured creditor that it had taken the steps necessary to acquire rights in the encumbered asset.

Priority of rights of persons providing services with respect to an encumbered asset

91. If law other than this law gives rights equivalent to security rights to a creditor that has provided services with respect to an encumbered asset (e.g. by repairing, storing or transporting it), such rights are limited to the assets in the possession of that creditor up to the reasonable value of the services rendered and have priority as against pre-existing security rights in the asset.

Priority of a supplier's reclamation right

92. If law other than this law provides that a supplier of goods has the right to reclaim the goods, the law should provide that the reclamation right is subordinate to a security right that was made effective against third parties before the supplier exercised its reclamation right.

Priority of a security right in an attachment

93. The law should provide that a security right or any other right (such as the right of a buyer or lessee) in an attachment to immovable property that is created and made effective against third parties under immovable property law, as provided in recommendations 22 and 44, has priority as against a security right in that attachment that is made effective against third parties by one of the methods referred to in recommendation 33 or 35.

94. The law should provide that a security right in tangible property that is an attachment to immovable property at the time the security right is made effective against third parties or that becomes an attachment to immovable property subsequently and that is made effective against third parties by registration in the immovable property registry as provided in recommendation 44, has priority as against a security right or any other right (such as the right of a buyer or lessor) in the related immovable property that is registered subsequently.

95. A security right or any other right (such as the right of a buyer or lessee) in an attachment to movable property that is made effective against third parties by registration in a specialized registry or by notation on a title certificate under

recommendation 43, has priority as against a security right or other right in the related movable property that is registered subsequently.

Priority of a security right in a mass or product

96. The law should provide that, where two or more security rights in the same tangible property continue in a mass or product as provided in recommendation 23, they retain the same priority as the security rights in the tangible property had as against each other immediately before the tangible property became part of the mass or product.

97. The law should provide that, if security rights in separate tangible property continue in the same mass or product and each security right is effective against third parties, the secured creditors are entitled to share in the aggregate maximum value of their security rights in the mass or product according to the ratio of the value of the respective security rights. For purposes of this formula, the maximum value of a security right is the lesser of the value provided in recommendation 23 and the amount of the secured obligations.

98. The law should provide that a security right in separate tangible property that continues in a mass or product and is effective against third parties, has priority as against a security right granted by the same grantor in the mass or product, if it is an acquisition security right.

B. Asset-specific recommendations

Priority of a security right in a negotiable instrument

99. The law should provide that a security right in a negotiable instrument that is made effective against third parties by possession of the instrument, as provided in recommendation 38, has priority as against a security right in a negotiable instrument that is made effective against third parties by any other method.

100. The law should provide that a security right in a negotiable instrument that is made effective against third parties by a method other than possession of the instrument is subordinate to the rights of a secured creditor, buyer or other transferee (in a consensual transaction) that:

(a) Qualifies as a protected holder under the law governing negotiable instruments; or

(b) Takes possession of the negotiable instrument and gives value in good faith and without knowledge that the transfer is in violation of the rights of the secured creditor under the security agreement.

Priority of a security right in a right to payment of funds credited to a bank account

101. The law should provide that a security right in a right to payment of funds credited to a bank account that is made effective against third parties by control, as provided in recommendation 50, has priority as against a competing security right that is made effective against third parties by any other method. If a depositary bank concludes control agreements with more than one secured creditor, priority among those secured creditors is determined according to the order in which the control agreements were concluded. If the secured creditor is the depositary bank, its

security right has priority as against any other security right (including a security right made effective against third parties by a control agreement with the depositary bank even if the depositary bank's security right is later in time) other than a security right of a secured creditor that has acquired control by becoming the account holder.

102. The law should provide that any right of the depositary bank, existing under law other than this law, to set off obligations owed to the depositary bank by the grantor against the grantor's right to payment of funds credited to a bank account has priority as against the security right of any secured creditor other than a secured creditor that has acquired control by becoming the account holder.

103. In the case of a transfer of funds from a bank account initiated by the grantor, the law should provide that the transferee of the funds takes free of a security right in the right to payment of funds credited to the bank account, unless the transferee has knowledge that the transfer violates the rights of the secured creditor under the security agreement. This recommendation does not lessen the rights of transferees of funds from bank accounts under law other than this law.

Priority of a security right in money

104. The law should provide that a person that obtains possession of money that is subject to a security right takes the money free of the security right, whether the money constitutes an original encumbered asset or proceeds, unless that person has knowledge that the transfer violates the rights of the secured creditor under the security agreement. This recommendation does not lessen the rights of holders of money under law other than this law.

Priority of a security right in proceeds under an independent undertaking

105. The law should provide that a security right in proceeds under an independent undertaking that has been made effective against third parties by control, as provided in recommendation 51, has, with respect to a particular guarantor/issuer, confirmer or nominated person giving value under an independent undertaking, priority as against the rights of all other secured creditors that have, with respect to that person, made their security right effective against third parties by a method other than control. If control has been achieved by acknowledgement and inconsistent acknowledgements have been given to more than one secured creditor by a person, priority among those secured creditors is determined according to the order in which the acknowledgements were given.

Priority of a security right in a negotiable document or goods covered by a negotiable document

106. The law should provide that a security right in a negotiable document and the goods covered thereby is subordinate to the rights under the law governing negotiable documents of a person to which the negotiable document has been duly negotiated.

107. The law should provide that a security right in a negotiable document that is made effective against third parties (which extends to the goods covered by the document as provided in recommendation 29) has priority as against a security right in the goods covered by the negotiable document that is made effective against third parties by a method other than that provided in recommendation 52 (by making the

security right in the document effective against third parties) while the goods are covered by the document.

[Note to the Commission: The Commission may wish to substitute recommendation 107 with wording along the following lines: “The law should provide that a security right in goods covered by a negotiable document is subordinate to the rights of a secured creditor, buyer or other transferee of the document (in a consensual transaction) that takes possession of the negotiable document while the goods are covered by the document and gives value in good faith and without knowledge that the transfer is in violation of the rights of the secured creditor under the security agreement.”]

VIII. Rights and obligations of the parties

Purpose

The purpose of the provisions of the law on rights and obligations of the parties is to enhance efficiency of secured transactions and reduce transaction costs and potential disputes by:

- (a) Providing rules on additional terms for the security agreement;
- (b) Eliminating the need to negotiate and draft terms to be included in the security agreement where the rules provide an acceptable basis for agreement;
- (c) Providing a drafting aid or checklist of issues the parties may wish to address at the time of negotiation and conclusion of the security agreement; and
- (d) Encouraging party autonomy.

A. General recommendations

Non-mandatory rules relating to the rights of the secured creditor

108. The law should provide that, unless otherwise agreed:

- (a) The secured creditor is entitled to be reimbursed for reasonable expenses incurred for the preservation of encumbered assets in its possession;
- (b) The secured creditor is entitled to make reasonable use of the encumbered assets in its possession and to inspect encumbered assets in the possession of the grantor.

Mandatory rules relating to the obligations of the party in possession

109. The law should provide that:

- (a) The secured creditor or the grantor in possession of the encumbered assets must take any steps necessary to preserve the encumbered assets;
- (b) The secured creditor must return the encumbered assets in its possession or terminate the notice registered upon full payment of the secured obligation and termination of all commitments to extend credit.

B. Asset-specific recommendations

Rights and obligations of the assignor and the assignee

[Note to the Commission: The Commission may wish to note that recommendations 110-113 are based on articles 11-14 of the United Nations Assignment Convention.]

110. The law should provide that:

(a) The mutual rights and obligations of the assignor and the assignee arising from their agreement are determined by the terms and conditions set forth in that agreement, including any rules or general conditions referred to therein;

(b) The assignor and the assignee are bound by any usage to which they have agreed and, unless otherwise agreed, by any practices they have established between themselves.

Representations of the assignor

111. With respect to an assignment of a contractual receivable, the law should provide that:

(a) Unless otherwise agreed between the assignor and the assignee, the assignor represents at the time of conclusion of the contract of assignment that:

(i) The assignor has the right to assign the receivable;

(ii) The assignor has not previously assigned the receivable to another assignee; and

(iii) The debtor of the receivable does not and will not have any defences or rights of set-off;

(b) Unless otherwise agreed between the assignor and the assignee, the assignor does not represent that the debtor of the receivable has, or will have, the ability to pay.

Right to notify the debtor of the receivable

112. The law should provide that:

(a) Unless otherwise agreed between the assignor and the assignee, the assignor or the assignee or both may send the debtor of the receivable notification of the assignment and a payment instruction, but after notification has been sent only the assignee may send such an instruction; and

(b) Notification of the assignment or a payment instruction sent in breach of any agreement referred to in subparagraph (a) of this recommendation is not ineffective for the purposes of recommendation 116 by reason of such breach. However, nothing in this recommendation affects any obligation or liability of the party in breach of such an agreement for any damages arising as a result of the breach.

Right to payment

113. The law should provide that:

(a) As between the assignor and the assignee, unless otherwise agreed and whether or not notification of the assignment has been sent:

(i) If payment in respect of the assigned receivable is made to the assignee, the assignee is entitled to retain the proceeds and goods returned in respect of the assigned receivable;

(ii) If payment in respect of the assigned receivable is made to the assignor, the assignee is entitled to payment of the proceeds and also to goods returned to the assignor in respect of the assigned receivable; and

(iii) If payment in respect of the assigned receivable is made to another person over whom the assignee has priority, the assignee is entitled to payment of the proceeds and also to goods returned to such person in respect of the assigned receivable;

(b) The assignee may not retain more than the value of its right in the receivable.

IX. Rights and obligations of third-party obligors**A. Rights and obligations of the debtor of the receivable****Protection of the debtor of the receivable**

[Note to the Commission: The Commission may wish to note that recommendations 114-120 are based on articles 15-21 of the United Nations Assignment Convention.]

114. The law should provide that:

(a) Except as otherwise provided in this law, an assignment does not, without the consent of the debtor of the receivable, affect the rights and obligations of the debtor of the receivable, including the payment terms contained in the original contract; (b) A payment instruction may change the person, address or account to which the debtor of the receivable is required to make payment, but may not change:

(i) The currency of payment specified in the original contract; or

(ii) The State specified in the original contract in which payment is to be made to a State other than that in which the debtor of the receivable is located.

Notification of the debtor of the receivable

115. The law should provide that:

(a) Notification of the assignment or a payment instruction is effective when received by the debtor of the receivable if it is in a language that is reasonably expected to inform the debtor of the receivable about its contents. It is sufficient if notification of the assignment or a payment instruction is in the language of the original contract;

(b) Notification of the assignment or a payment instruction may relate to receivables arising after notification; and

(c) Notification of a subsequent assignment constitutes notification of all prior assignments.

Discharge of the debtor of the receivable by payment

116. The law should provide that:

(a) Until the debtor of the receivable receives notification of the assignment, it is entitled to be discharged by paying in accordance with the original contract;

(b) After the debtor of the receivable receives notification of the assignment, subject to subparagraphs (c)-(h) of this recommendation, it is discharged only by paying the assignee or, if otherwise instructed in the notification of the assignment or subsequently by the assignee in a writing received by the debtor of the receivable, in accordance with such payment instruction;

(c) If the debtor of the receivable receives more than one payment instruction relating to a single assignment of the same receivable by the same assignor, it is discharged by paying in accordance with the last payment instruction received from the assignee before payment;

(d) If the debtor of the receivable receives notification of more than one assignment of the same receivable made by the same assignor, it is discharged by paying in accordance with the first notification received;

(e) If the debtor of the receivable receives notification of one or more subsequent assignments, it is discharged by paying in accordance with the notification of the last of such subsequent assignments;

(f) If the debtor of the receivable receives notification of the assignment of a part of or an undivided interest in one or more receivables, it is discharged by paying in accordance with the notification or in accordance with this recommendation as if the debtor of the receivable had not received the notification. If the debtor of the receivable pays in accordance with the notification, it is discharged only to the extent of the part or undivided interest paid;

(g) If the debtor of the receivable receives notification of the assignment from the assignee, it is entitled to request the assignee to provide within a reasonable period of time adequate proof that the assignment from the initial assignor to the initial assignee and any intermediate assignment have been made and, unless the assignee does so, the debtor of the receivable is discharged by paying in accordance with this recommendation as if the notification from the assignee had not been received. Adequate proof of an assignment includes but is not limited to any writing emanating from the assignor and indicating that the assignment has taken place; and

(h) This recommendation does not affect any other ground on which payment by the debtor of the receivable to the person entitled to payment, to a competent judicial or other authority, or to a public deposit fund discharges the debtor of the receivable.

Defences and rights of set-off of the debtor of the receivable

117. The law should provide that:

(a) In a claim by the assignee against the debtor of the receivable for payment of the assigned receivable, the debtor of the receivable may raise against the assignee all defences and rights of set-off arising from the original contract, or any other contract that was part of the same transaction, of which the debtor of the

receivable could avail itself as if the assignment had not been made and such claim were made by the assignor;

(b) The debtor of the receivable may raise against the assignee any other right of set off, provided that it was available to the debtor of the receivable at the time notification of the assignment was received by the debtor of the receivable; and

(c) Notwithstanding subparagraphs (a) and (b) of this recommendation, defences and rights of set-off that the debtor of the receivable may raise pursuant to recommendation 25, subparagraph (b), or recommendation 26, subparagraph (e), against the assignor for breach of an agreement limiting in any way the assignor's right to make the assignment are not available to the debtor of the receivable against the assignee.

Agreement not to raise defences or rights of set-off

118. The law should provide that:

(a) The debtor of the receivable may agree with the assignor in a writing signed by the debtor of the receivable not to raise against the assignee the defences and rights of set-off that it could raise pursuant to recommendation 117. Such an agreement precludes the debtor of the receivable from raising against the assignee those defences and rights of set-off;

(b) The debtor of the receivable may not waive defences:

- (i) Arising from fraudulent acts on the part of the assignee; or
- (ii) Based on the incapacity of the debtor of the receivable; and

(c) Such an agreement may be modified only by an agreement in a writing signed by the debtor of the receivable. The effect of such a modification as against the assignee is determined by recommendation 119, subparagraph (b).

Modification of the original contract

119. The law should provide that:

(a) An agreement concluded before notification of the assignment between the assignor and the debtor of the receivable that affects the assignee's rights is effective as against the assignee, and the assignee acquires corresponding rights;

(b) An agreement concluded after notification of the assignment between the assignor and the debtor of the receivable that affects the assignee's rights is ineffective as against the assignee unless:

- (i) The assignee consents to it; or
- (ii) The receivable is not fully earned by performance and either the modification is provided for in the original contract or, in the context of the original contract, a reasonable assignee would consent to the modification; and

(c) Subparagraphs (a) and (b) of this recommendation do not affect any right of the assignor or the assignee arising from breach of an agreement between them.

Recovery of payments

120. The law should provide that failure of the assignor to perform the original contract does not entitle the debtor of the receivable to recover from the assignee a sum paid by the debtor of the receivable to the assignor or the assignee.

B. Rights and obligations of the obligor under a negotiable instrument

121. The law should provide that a secured creditor's rights in a negotiable instrument are, as against a person obligated on the negotiable instrument or any other person claiming rights under the law governing negotiable instruments, subject to the law governing negotiable instruments.

C. Rights and obligations of the depositary bank

122. The law should provide that:

(a) The creation of a security right in a right to payment of funds credited to a bank account does not affect the rights and obligations of the depositary bank without its consent; and

(b) Any rights of set-off that the depositary bank may have under law other than this law are not impaired by reason of any security right that the depositary bank may have in a right to payment of funds credited to a bank account.

123. The law should provide that nothing in the law obligates a depositary bank:

(a) To pay any person other than a person that has control with respect to funds credited to a bank account; or

(b) To respond to requests for information about whether a control agreement or a security right in its own favour exists and whether the grantor retains the right to dispose of the funds credited in the account.

D. Rights and obligations of the guarantor/issuer, confirmer or nominated person of an independent undertaking

124. The law should provide that:

(a) A secured creditor's rights in proceeds under an independent undertaking are subject to the rights, under the law and practice governing independent undertakings, of the guarantor/issuer, confirmer or nominated person and of any other beneficiary named in the undertaking or to whom a transfer of drawing rights has been effected;

(b) The rights of a transferee of an independent undertaking are not affected by a security right in proceeds under the independent undertaking acquired from the transferor or any prior transferor; and

(c) The independent rights of a guarantor/issuer, confirmer, nominated person or transferee of an independent undertaking are not adversely affected by reason of any security right it may have in rights in proceeds under the independent undertaking, including any right in proceeds under the independent undertaking resulting from a transfer of drawing rights to a transferee.

125. The law should provide that a guarantor/issuer, confirmer or nominated person is not obligated to pay any person other than a confirmer, a nominated person, a named beneficiary, an acknowledged transferee of the independent undertaking or an acknowledged assignee of the proceeds under an independent undertaking.

126. The law should provide that, if a secured creditor obtains control by becoming an acknowledged assignee of the proceeds under an independent undertaking, the secured creditor has the right to enforce the acknowledgement against the guarantor/issuer, confirmer or nominated person that made the acknowledgement.

E. Rights and obligations of the issuer of a negotiable document

127. The law should provide that a secured creditor's rights in a negotiable document are, as against the issuer or any other person obligated on the negotiable document, subject to the law governing negotiable documents.

X. Post-default rights

Purpose

The purpose of the provisions of the law on post-default rights is to provide:

(a) Clear and simple methods for the enforcement of security rights after debtor default in a predictable and efficient manner;

(b) Methods that maximize the amount realized from the encumbered assets for the benefit of the grantor, the debtor or any other person that owes payment of the secured obligation, the secured creditor and other creditors with a right in the encumbered assets;

(c) Expeditious judicial and, subject to appropriate safeguards, non-judicial methods for the secured creditor to realize the value of the encumbered assets.

A. General recommendations

General standard of conduct in the context of enforcement

128. The law should provide that a person must enforce its rights and perform its obligations under the provisions of this law governing post-default rights in good faith and in a commercially reasonable manner.

Limitations on party autonomy

129. The law should provide that the general standard of conduct provided in recommendation 128 cannot be waived unilaterally or varied by agreement at any time.

130. The law should provide that, subject to recommendation 129, the grantor and any other person that owes payment or other performance of the secured obligation may waive unilaterally or vary by agreement any of its rights under the provisions of this law governing post-default rights, but only after default.

131. The law should provide that, subject to recommendation 129, the secured creditor may waive unilaterally or vary by agreement any of its rights under the provisions of this law governing post-default rights at any time.

132. The law should provide that a variation of rights by agreement does not affect the rights of any person not a party to the agreement. A person challenging the agreement has the burden of showing that it was made prior to default or is inconsistent with recommendation 128 or 129.

Liability

133. The law should provide that, if a person fails to comply with its obligations under the provisions of this law governing post-default rights, it is liable to damages.

[Note to the Commission: The Commission may wish to note that recommendations 134 and 135 are not intended to state the relevant rules but rather to list, for the ease of the reader, the various post-default rights of the secured creditor and the grantor, and to refer to the following recommendations that state the relevant rules.]

Post-default rights of the secured creditor

134. The law should provide that after default the secured creditor is entitled to exercise one or more of the following rights with respect to an encumbered asset:

(a) Obtain possession of a tangible encumbered asset, as provided in recommendations 142 and 143;

(b) Sell or otherwise dispose of, lease or license an encumbered asset, as provided in recommendations 144-147;

(c) Propose to the grantor that the secured creditor accept an encumbered asset in total or partial satisfaction of the secured obligation, as provided in recommendations 148-150;

(d) Collect on or otherwise enforce a security right in an encumbered asset that is a receivable, negotiable instrument, right to payment of funds credited to a bank account or proceeds under an independent undertaking, as provided in recommendations 162-170;

(e) Enforce rights under a negotiable document, as provided in recommendation 171;

(f) Enforce its security right in an attachment to immovable property, as provided in recommendation 172; and

(g) Exercise any other right provided in the security agreement (except to the extent inconsistent with the provisions of this law) or any law.

Post-default rights of the grantor

135. The law should provide that after default the grantor is entitled to exercise one or more of the following rights:

(a) Pay in full the secured obligation and obtain a release from the security right of all encumbered assets, as provided in recommendation 140;

(b) Apply to a court or other authority for relief if the secured creditor is not complying with its obligations under the provisions of this law, as provided in recommendation 141;

(c) Propose to the secured creditor, or reject the proposal of the secured creditor, that the secured creditor accept an encumbered asset in total or partial satisfaction of the secured obligation, as provided in recommendation 151; and

(d) Exercise any other right provided in the security agreement or any law.

Judicial and extrajudicial methods of exercising post-default rights

136. The law should provide that after default the secured creditor may exercise its rights provided in recommendation 134 by applying to a court or other authority. Subject to the general standard of conduct provided in recommendation 128 and the requirements provided in recommendations 142-147 with respect to extrajudicial obtaining of possession and disposition of an encumbered asset, the secured creditor may elect to exercise its rights provided in recommendation 134 without having to apply to a court or other authority.

Expeditious judicial proceedings

137. The law should provide for expeditious judicial proceedings with respect to the exercise of post-default rights of the secured creditor, the grantor and any other person that owes performance of the secured obligation or claims to have a right in an encumbered asset.

Cumulative post-default rights

138. The law should provide that the exercise of a post-default right does not prevent the exercise of another right, except to the extent that the exercise of a right has made the exercise of another right impossible.

Post-default rights with respect to the secured obligation

139. The law should provide that the exercise of a post-default right with respect to an encumbered asset does not prevent the exercise of a post-default right with respect to the obligation secured by that asset, and vice versa.

Release of the encumbered assets after full payment

140. The law should provide that, after default and until the disposition, acceptance or collection of an encumbered asset by the secured creditor, the debtor, the grantor or any other interested person (e.g. a secured creditor whose security right has lower priority than that of the enforcing secured creditor, a guarantor or a co-owner of the encumbered asset) is entitled to pay the secured obligation in full, including interest and the costs of enforcement up to the time of full payment. If all commitments to extend credit have terminated, full payment extinguishes the security right in all encumbered assets, subject to any rights of subrogation in favour of the person making the payment.

Judicial or other relief for non-compliance

141. The law should provide that the debtor, the grantor or any other interested person (e.g. a secured creditor with a lower priority ranking than that of the enforcing secured creditor, a guarantor or a co-owner of the encumbered assets) is

entitled at any time to apply to a court or other authority for relief from the secured creditor's failure to comply with its obligations under the provisions of this law governing post-default rights. Unfounded applications and improper interference with or undue delay of the enforcement process should be discouraged and avoided.

[Note to the Commission: The Commission may wish to consider whether the last sentence of this recommendation should be retained in the recommendation or placed in the commentary.]

Secured creditor's right to possession of an encumbered asset

142. The law should provide that after default the secured creditor is entitled to possession of a tangible encumbered asset.

Extrajudicial obtaining of possession of an encumbered asset

143. The law should provide that the secured creditor may elect to obtain possession of a tangible encumbered asset without applying to a court or other authority only if:

(a) The grantor has consented in the security agreement to the secured creditor obtaining possession without applying to a court or other authority;

(b) The secured creditor has given the grantor and any person in possession of the encumbered asset notice of default and of the secured creditor's intent to obtain possession without applying to a court or other authority; and

(c) At the time the secured creditor seeks to obtain possession of the encumbered asset the grantor does not object.

Extrajudicial disposition of an encumbered asset

144. The law should provide that after default a secured creditor is entitled to sell or otherwise dispose of, lease or license an encumbered asset to the extent of the grantor's rights in the encumbered asset. Subject to the standard of conduct provided in recommendation 128, a secured creditor that elects to exercise this right without applying to a court or other authority may select the method, manner, time, place and other aspects of the disposition, lease or licence.

Advance notice of extrajudicial disposition of an encumbered asset

145. The law should provide that after default the secured creditor must give notice of its intention to sell or otherwise dispose of, lease or licence an encumbered asset without applying to a court or other authority. The notice need not be given if the encumbered asset is perishable, may decline in value speedily or is of a kind sold on a recognized market.

146. The law should provide rules ensuring that the notice referred to in recommendation 145 can be given in an efficient, timely and reliable way so as to protect the grantor or other interested parties, while, at the same time, avoiding having a negative effect on the secured creditor's remedies and the potential net realization value of the encumbered assets.

147. With respect to the notice referred to in recommendation 145, the law should:

(a) Provide that the notice must be [given to] [received by]:

(i) The grantor, the debtor and any other person that owes payment of the secured obligation;

(ii) Any person with rights in the encumbered asset that, more than [to be specified] days before the sending of the notice by the secured creditor to the grantor, notifies in writing the secured creditor of those rights; and

(iii) Any other secured creditor that, more than [to be specified] days before the notice is sent to the grantor, registered a notice of a security right in the encumbered asset under the name of the grantor; and

(iv) Any other secured creditor that was in possession of the encumbered asset at the time when the enforcing secured creditor took possession of the asset;

(b) State the manner in which the notice must be given, its timing and its minimum contents, including whether the notice must contain an accounting of the amount then owed and a reference to the right of the debtor or the grantor to obtain the release of the encumbered assets from the security right as provided in recommendation 140; and

(c) Provide that the notice must be in a language that is reasonably expected to inform its recipients about its contents.

Acceptance of encumbered assets in satisfaction of the secured obligation

148. The law should provide that after default the secured creditor may propose in writing that the secured creditor accept one or more of the encumbered assets in total or partial satisfaction of the secured obligation.

149. With respect to the proposal referred to in recommendation 148, the law should:

(a) Provide that the proposal must be [given to] [received by]:

(i) The grantor, the debtor and any other person that owes payment of the secured obligation (e.g. a guarantor);

(ii) Any person with rights in the encumbered asset that, more than [to be specified] days prior to the sending of the proposal by the secured creditor to the grantor, has notified in writing the secured creditor of those rights; and

(iii) Any other secured creditor that, more than [to be specified] days before the proposal is [sent to] [received by] the grantor, registered a notice of a security right in the encumbered asset in the name of the grantor;

(iv) Any other secured creditor that was in possession of the encumbered asset at the time it was seized by the secured creditor; and

(b) Provide that the proposal must specify the amount owed as of the date the proposal is [sent] [received] and the amount of the obligation that is proposed to be satisfied by accepting the encumbered asset.

150. The law should provide that the secured creditor may proceed with the proposal referred to in recommendation 148, unless any addressee of a proposal under recommendation 149 objects in writing within a short time, such as [to be specified] days, after the proposal is [sent] [received]. [In the case of a proposal for

the acceptance of the encumbered asset in partial satisfaction, affirmative consent by any addressee of the proposal is necessary.]

151. The law should provide that the grantor may make a proposal such as that referred to in recommendation 148 and if the secured creditor accepts it, the secured creditor must proceed as provided in recommendations 149 and 150.

Distribution of proceeds of extrajudicial disposition of an encumbered asset

152. The law should provide that, in the case of extrajudicial disposition of an encumbered asset or collection of a receivable, negotiable instrument or other obligation, the enforcing secured creditor must apply the net proceeds of its enforcement (after deducting costs of enforcement) to the secured obligation. Except as provided in recommendation 153, the enforcing secured creditor must pay any surplus remaining to any subordinate competing claimant, that, prior to any distribution of the surplus, notified the enforcing secured creditor of the subordinate competing claimant's claim, to the extent of that claim. Any balance remaining must be remitted to the grantor.

153. The law should also provide that, in the case of extrajudicial enforcement, whether or not there is any dispute as to the entitlement of any competing claimant or as to the priority of payment, the enforcing secured creditor may, in accordance with generally applicable procedural rules, pay the surplus to a competent judicial or other authority or to a public deposit fund for distribution. The surplus should be distributed in accordance with the priority rules of this law.

154. The law should provide that distribution of the proceeds realized by a judicial disposition or other officially administered enforcement process is to be made pursuant to the general rules of the State governing execution proceedings, but in accordance with the priority rules of this law.

155. The law should provide that, unless otherwise agreed, the debtor and any other person that owes payment of the secured obligation are liable for any shortfall still owing after application of the net proceeds of enforcement to the secured obligation.

Right of prior-ranking secured creditor to take over enforcement

156. The law should provide that, where a secured creditor or a judgement creditor has commenced enforcement, a secured creditor whose security right has priority as against that of the enforcing secured creditor or the enforcing judgement creditor is entitled to take control of the enforcement process at any time before final disposition, acceptance or collection of an encumbered asset. The right to take control includes the right to enforce by any method available under this law.

Rights acquired through judicial disposition

157. The law should provide that, if a secured creditor disposes of an encumbered asset through a judicial or other officially administered process, the rights acquired by the transferee are determined by the general rules of the State governing execution proceedings.

Rights acquired through extrajudicial disposition

158. The law should provide that, if a secured creditor sells or otherwise disposes of an encumbered asset without applying to a court or other authority, in accordance with this

law, a person that acquires the grantor's right in the asset takes the asset subject to rights that have priority as against the security right of the enforcing secured creditor, but free of rights of the enforcing secured creditor and any competing claimant whose right has a lower priority than that of the enforcing secured creditor. The same rule applies to rights in an encumbered asset acquired by a secured creditor that has accepted the asset in total or partial satisfaction of the secured obligation.

159. The law should provide that, if a secured creditor leases or licenses an encumbered asset without applying to a court or other authority, in accordance with the law, a lessee or licensee is entitled to the benefit of the lease or licence during the term thereof, except as against rights that have priority as against the security right of the enforcing secured creditor.

160. The law should provide that if the secured creditor sells or otherwise disposes of, leases or licenses the encumbered asset not in accordance with the law, a good faith acquirer, lessee or licensee of the encumbered asset acquires the rights or benefits described in recommendations 158 and 159.

Intersection of movable and immovable property enforcement regimes

161. The law should provide that:

(a) The secured creditor may elect to enforce a security right in an attachment to immovable property in accordance with this law or the law governing enforcement of encumbrances in immovable property; and

(b) If an obligation is secured by both movable and immovable property of a grantor, the secured creditor may elect to enforce:

(i) The security right in the movable property under this law and the encumbrance in the immovable property under the law governing enforcement of encumbrances in immovable property; or

(ii) Both rights under the law governing enforcement of encumbrances in immovable property.

B. Asset-specific recommendations

Application of the chapter on post-default rights to outright transfers of receivables

162. The law should provide that the provisions of the law on post-default rights do not apply to the collection or other enforcement of a receivable transferred by an outright transfer with the exception of:

(a) Recommendation 128 in the case of an outright transfer with recourse; and

(b) Recommendations 163 and 164.

Enforcement of a security right in a receivable

163. The law should provide that, in the case of a receivable transferred by an outright transfer, the assignee has the right to collect or otherwise enforce the receivable. In the case of a receivable transferred by way of security, the assignee is entitled, subject to recommendations 114-120, to collect or otherwise enforce the receivable after default, or before default with the agreement of the assignor.

164. The law should provide that the assignee's right to collect or otherwise enforce a receivable includes the right to collect or otherwise enforce any personal or property right that secures payment of the receivable.

Enforcement of a security right in a negotiable instrument

165. The law should provide that after default, or before default with the agreement of the grantor, the secured creditor is entitled, subject to recommendation 121, to collect or otherwise enforce a negotiable instrument that is an encumbered asset against a person obligated on that instrument.

166. The law should provide that the secured creditor's right to collect or otherwise enforce a negotiable instrument includes the right to collect or otherwise enforce any personal or property right that secures payment of the negotiable instrument.

Enforcement of a security right in a right to payment of funds credited to a bank account

167. The law should provide that after default, or before default with the agreement of the grantor, a secured creditor with a security right in a right to payment of funds credited to a bank account is entitled, subject to recommendations 122 and 123, to collect or otherwise enforce its right to payment of the funds.

168. The law should provide that a secured creditor that has control is entitled, subject to recommendations 122 and 123, to enforce its security right without having to apply to a court or other authority.

169. The law should provide that a secured creditor that does not have control is entitled, subject to recommendations 122 and 123, to collect or otherwise enforce the security right against the depositary bank only pursuant to a court order, unless the depositary bank agrees otherwise.

Enforcement of a security right in proceeds under an independent undertaking

170. The law should provide that after default, or before default with the agreement of the grantor, a secured creditor with a security right in proceeds under an independent undertaking is entitled, subject to recommendations 124-126, to collect or otherwise enforce its right in the proceeds under the independent undertaking.

Enforcement of a security right in a negotiable document or goods covered by a negotiable document

171. The law should provide that after default, or before default with the agreement of the grantor, the secured creditor is entitled, subject to recommendation 127, to enforce a security right in a negotiable document against the issuer or any other person obligated on the negotiable document.

Enforcement of a security right in an attachment to immovable property

172. The law should provide that a secured creditor with a security right in an attachment to immovable property is entitled to enforce its security right only if it has priority as against competing rights in the immovable property. A creditor with a competing right in immovable property that has lower priority ranking is entitled to pay off the obligation secured by the security right of the enforcing secured creditor in the attachment. The enforcing secured creditor is liable for any damage to the

immovable property caused by the act of removal other than any diminution in its value attributable solely to the absence of the attachment.

XI. Insolvency

A. *UNCITRAL Legislative Guide on Insolvency Law*:¹ definitions and recommendations

Definitions

12. (b) “Assets of the debtor”: property, rights and interests of the debtor, including rights and interests in property, whether or not in the possession of the debtor, tangible or intangible, movable or immovable, including the debtor’s interests in encumbered assets or in third-party-owned assets;

12. (r) “Financial contract”: any spot, forward, future, option or swap transaction involving interest rates, commodities, currencies, equities, bonds, indices or any other financial instrument, any repurchase or securities lending transaction, and any other transaction similar to any transaction referred to above entered into in financial markets and any combination of the transactions mentioned above;

12. (x) “*Lex fori concursus*”: the law of the State in which the insolvency proceedings are commenced;

12. (y) “*Lex rei sitae*”: the law of the State in which the asset is situated;

12. (z) “Netting”: the setting-off of monetary or non-monetary obligations under financial contracts;

12. (aa) “Netting agreement”: a form of financial contract between two or more parties that provides for one or more of the following:

(i) The net settlement of payments due in the same currency on the same date whether by novation or otherwise;

(ii) Upon the insolvency or other default by a party, the termination of all outstanding transactions at their replacement or fair market values, conversion of such sums into a single currency and netting into a single payment by one party to the other; or

(iii) The set-off of amounts calculated as set forth in subparagraph (ii) of this definition under two or more netting agreements.²

12. (dd) “Party in interest”: any party whose rights, obligations or interests are affected by insolvency proceedings or particular matters in the insolvency proceedings, including the debtor, the insolvency representative, a creditor, an equity holder, a creditor committee, a government authority or any other person so affected. It is not intended that persons with remote or diffuse interests affected by the insolvency proceedings would be considered to be a party in interest;

12. (ff) “Preference”: a transaction which results in a creditor obtaining an advantage or irregular payment;

¹ United Nations publication, E.05.V.10.

² United Nations Convention on the Assignment of Receivables in International Trade (United Nations publication, Sales No. E.04.V.14), article 5, subparagraph (1).

12. (gg) “Priority”: the right of a claim to rank ahead of another claim where that right arises by operation of law;
12. (hh) “Priority claim”: a claim that will be paid before payment of general unsecured creditors;
12. (ii) “Protection of value”: measures directed at maintaining the economic value of encumbered assets and third-party-owned assets during the insolvency proceedings (in some jurisdictions referred to as “adequate protection”). Protection may be provided by way of cash payments, provision of security interests over alternative or additional assets or by other means as determined by a court to provide the necessary protection;
12. (pp) “Security interest”: a right in an asset to secure payment or other performance of one or more obligations.

Recommendations

Key objectives of an efficient and effective insolvency law

(1) In order to establish and develop an effective insolvency law, the following key objectives should be considered:

- (a) Provide certainty in the market to promote economic stability and growth;
- (b) Maximize value of assets;
- (c) Strike a balance between liquidation and reorganization;
- (d) Ensure equitable treatment of similarly situated creditors;
- (e) Provide for timely, efficient and impartial resolution of insolvency;
- (f) Preserve the insolvency estate to allow equitable distribution to creditors;
- (g) Ensure a transparent and predictable insolvency law that contains incentives for gathering and dispensing information; and
- (h) Recognize existing creditors’ rights and establish clear rules for ranking of priority claims.

(4) The insolvency law should specify that where a security interest is effective and enforceable under law other than the insolvency law, it will be recognized in insolvency proceedings as effective and enforceable.

(7) In order to design an effective and efficient insolvency law, the following common features should be considered:

(a)-(d) ...

(e) Protection of the insolvency estate against the actions of creditors, the debtor itself and the insolvency representative, and where the protective measures apply to secured creditors, the manner in which the economic value of the security interest will be protected during the insolvency proceedings;

(f)-(r) ...

Law applicable to validity and effectiveness of rights and claims

(30) The law applicable to the validity and effectiveness of rights and claims existing at the time of the commencement of insolvency proceedings should be

determined by the private international law rules of the State in which insolvency proceedings are commenced.

Law applicable in insolvency proceedings: lex fori concursus

(31) The insolvency law of the State in which insolvency proceedings are commenced (*lex fori concursus*) should apply to all aspects of the commencement, conduct, administration and conclusion of those insolvency proceedings and their effects. These may include, for example:

- (a)-(i) ...
- (j) Treatment of secured creditors;
- (k)-(n) ...
- (o) Ranking of claims;
- (p)-(s) ...

Assets constituting the insolvency estate

(35) The insolvency law should specify that the estate should include:

- (a) Assets of the debtor,³ including the debtor's interest in encumbered assets and in third-party-owned assets;
- (b) Assets acquired after commencement of the insolvency proceedings; and
- (c) ...

*Provisional measures*⁴

(39) The insolvency law should specify that the court may grant relief of a provisional nature, at the request of the debtor, creditors or third parties, where relief is needed to protect and preserve the value of the assets of the debtor⁵ or the interests of creditors, between the time an application to commence insolvency proceedings is made and commencement of the proceedings,⁶ including:

- (a) Staying execution against the assets of the debtor, including actions to make security interests effective against third parties and enforcement of security interests;
- (b)-(d) ...

³ Ownership of assets would be determined by reference to the relevant applicable law, where the term "assets" is defined broadly to include property, rights and interest of the debtor, including the debtor's rights and interests in third-party-owned assets.

⁴ These articles follow the corresponding articles of the UNCITRAL Model Law on Cross-Border Insolvency, see article 19 (see annex III of the *UNCITRAL Insolvency Guide*).

⁵ The reference to assets in paragraphs (a)-(c) is intended to be limited to assets that would be part of the insolvency estate once proceedings commence.

⁶ The insolvency law should indicate the time of effect of an order for provisional measures, for example, at the time of the making of the order, retrospectively from the commencement of the day on which the order is made or some other specified time (see para. 44 of the *UNCITRAL Insolvency Guide*).

Measures applicable on commencement

(46) The insolvency law should specify that, on commencement of insolvency proceedings:⁷

(a) Commencement or continuation of individual actions or proceedings⁸ concerning the assets of the debtor, and the rights, obligations or liabilities of the debtor are stayed;

(b) Actions to make security interests effective against third parties and to enforce security interests are stayed;⁹

(c) Execution or other enforcement against the assets of the estate is stayed;

(d) The right of a counterparty to terminate any contract with the debtor is suspended;¹⁰ and

(e) The right to transfer, encumber or otherwise dispose of any assets of the estate is suspended.¹¹

Duration of measures automatically applicable on commencement

(49) The insolvency law should specify that the measures applicable on commencement of insolvency proceedings remain effective throughout those proceedings until:

(a) The court grants relief from the measures;¹²

(b) In reorganization proceedings, a reorganization plan becomes effective;¹³
or

⁷ These measures would generally be effective as at the time of the making of the order for commencement.

⁸ See UNCITRAL Model Law on Cross-Border Insolvency, article 20 (see annex III of the *UNCITRAL Insolvency Guide*). It is intended that the individual actions referred to in subparagraph (a) of recommendation 46 would also cover actions before an arbitral tribunal. It may not always be possible, however, to implement the automatic stay of arbitral proceedings, such as where the arbitration does not take place in the State but in a foreign location.

⁹ If law other than the insolvency law permits those security interests to be made effective within certain specified time periods, it is desirable that the insolvency law recognize those periods and permit the interest to be made effective where the commencement of insolvency proceedings occurs before expiry of the specified time period. Where law other than the insolvency law does not include such time periods, the stay applicable on commencement would operate to prevent the security interest being made effective. (For further discussion see para. 32 of the *UNCITRAL Insolvency Guide*, and the UNCITRAL Legislative Guide on Secured Transactions.)

¹⁰ See *UNCITRAL Insolvency Guide*, paragraphs 114-119. This recommendation is not intended to preclude the termination of a contract if the contract provides for a termination date that happens to fall after the commencement of insolvency proceedings.

¹¹ The limitation on the right to transfer, encumber or otherwise dispose of assets of the estate may be subject to an exception in those cases where the continued operation of the business by the debtor is authorized and the debtor can transfer, encumber or otherwise dispose of assets in the ordinary course of business.

¹² Relief should be granted on the grounds included in recommendation 51 of the *UNCITRAL Insolvency Guide*.

¹³ A plan may become effective upon approval by creditors or following confirmation by the court, depending upon the requirements of the insolvency law (see *UNCITRAL Insolvency Guide*, chap. IV, paras. 54 and following).

(c) In the case of secured creditors in liquidation proceedings, a fixed time period specified in the law expires,¹⁴ unless it is extended by the court for a further period on a showing that:

- (i) An extension is necessary to maximize the value of assets for the benefit of creditors; and
- (ii) The secured creditor will be protected against diminution of the value of the encumbered asset in which it has a security interest.

Protection from diminution of the value of encumbered assets

(50) The insolvency law should specify that, upon application to the court, a secured creditor should be entitled to protection of the value of the asset in which it has a security interest. The court may grant appropriate measures of protection that may include:

- (a) Cash payments by the estate;
- (b) Provision of additional security interests; or
- (c) Such other means as the court determines.

Relief from measures applicable on commencement

(51) The insolvency law should specify that a secured creditor may request the court to grant relief from the measures applicable on commencement of insolvency proceedings on grounds that may include that:

- (a) The encumbered asset is not necessary to a prospective reorganization or sale of the debtor's business;
- (b) The value of the encumbered asset is diminishing as a result of the commencement of insolvency proceedings and the secured creditor is not protected against that diminution of value; and
- (c) In reorganization, a plan is not approved within any applicable time limits.

Power to use and dispose of assets of the estate

(52) The insolvency law should permit:

- (a) The use and disposal of assets of the estate (including encumbered assets) in the ordinary course of business, except cash proceeds; and
- (b) The use and disposal of assets of the estate (including encumbered assets) outside the ordinary course of business, subject to the requirements of recommendations 55 and 58.

Further encumbrance of encumbered assets

(53) The insolvency law should specify that encumbered assets may be further encumbered, subject to the requirements of recommendations 65-67.

¹⁴ It is intended that the stay should apply to secured creditors only for a short period of time, such as between 30 and 60 days, and that the insolvency law should clearly state the period of application.

Use of third-party-owned assets

(54) The insolvency law should specify that the insolvency representative may use an asset owned by a third party and in the possession of the debtor provided specified conditions are satisfied, including:

- (a) The interests of the third party will be protected against diminution in the value of the asset; and
- (b) The costs under the contract of continued performance of the contract and use of the asset will be paid as an administrative expense.

Ability to sell assets of the estate free and clear of encumbrances and other interests

(58) The insolvency law should permit the insolvency representative to sell assets that are encumbered or subject to other interest free and clear of that encumbrance and other interest, outside the ordinary course of business, provided that:

- (a) The insolvency representative gives notice of the proposed sale to the holders of encumbrances or other interests;
- (b) The holder is given the opportunity to be heard by the court where they object to the proposed sale;
- (c) Relief from the stay has not been granted; and
- (d) The priority of interests in the proceeds of sale of the asset is preserved.

Use of cash proceeds

(59) The insolvency law should permit the insolvency representative to use and dispose of cash proceeds if:

- (a) The secured creditor with a security interest in those cash proceeds consents to such use or disposal; or
- (b) The secured creditor was given notice of the proposed use or disposal and an opportunity to be heard by the court; and
- (c) The interests of the secured creditor will be protected against diminution in the value of the cash proceeds.

Burdensome assets

(62) The insolvency law should permit the insolvency representative to determine the treatment of any asset that is burdensome to the estate. In particular, the insolvency law may permit the insolvency representative to relinquish a burdensome asset following the provision of notice to creditors and the opportunity for creditors to object to the proposed action, except that where a secured claim exceeds the value of the encumbered asset, and the asset is not required for a reorganization or sale of the business as a going concern, the insolvency law may permit the insolvency representative to relinquish the asset to the secured creditor without notice to other creditors.

Security for post-commencement finance

(65) The insolvency law should enable a security interest to be granted for repayment of post-commencement finance, including a security interest on an unencumbered asset, including an after-acquired asset, or a junior or lower priority security interest on an already encumbered asset of the estate.

(66) The law¹⁵ should specify that a security interest over the assets of the estate to secure post-commencement finance does not have priority ahead of any existing security interest over the same assets unless the insolvency representative obtains the agreement of the existing secured creditor(s) or follows the procedure in recommendation 67.

(67) The insolvency law should specify that, where the existing secured creditor does not agree, the court may authorize the creation of a security interest having priority over pre-existing security interests provided specified conditions are satisfied, including:

- (a) The existing secured creditor was given the opportunity to be heard by the court;
- (b) The debtor can prove that it cannot obtain the finance in any other way; and
- (c) The interests of the existing secured creditor will be protected.¹⁶

Effect of conversion on post-commencement finance

(68) The insolvency law should specify that where reorganization proceedings are converted to liquidation, any priority accorded to post-commencement finance in the reorganization should continue to be recognized in the liquidation.¹⁷

Automatic termination and acceleration clauses

(70) The insolvency law should specify that any contract clause that automatically terminates or accelerates a contract upon the occurrence of any of the following events is unenforceable as against the insolvency representative and the debtor:

- (a) An application for commencement, or commencement, of insolvency proceedings;
- (b) The appointment of an insolvency representative.¹⁸

(71) The insolvency law should specify the contracts that are exempt from the operation of recommendation 70, such as financial contracts, or subject to special rules, such as labour contracts.

Continuation or rejection

(72) The insolvency law should specify that the insolvency representative may decide to continue the performance of a contract of which it is aware where

¹⁵ This rule may be in a law other than the insolvency law, in which case the insolvency law should note the existence of the provision.

¹⁶ See *UNCITRAL Insolvency Guide*, paragraphs 63-69.

¹⁷ The same order of priority may not necessarily be recognized. For example, post-commencement finance may rank in priority after administrative claims relating to the costs of the liquidation.

¹⁸ This recommendation would apply only to those contracts where such clauses could be overridden (see commentary of the *UNCITRAL Insolvency Guide*, paras. 143-145, on exceptions) and is not intended to be exclusive, but to establish a minimum: the court should be able to examine other contractual clauses that would have the effect of terminating a contract on the occurrence of similar events.

continuation would be beneficial to the insolvency estate.¹⁹ The insolvency law should specify that:

- (a) The right to continue applies to the contract as a whole; and
- (b) The effect of continuation is that all terms of the contract are enforceable.

Performance prior to continuation or rejection

(80) The insolvency law should specify that the insolvency representative may accept or require performance from the counterparty to a contract prior to continuation or rejection of the contract. Claims of the counterparty arising from performance accepted or required by the insolvency representative prior to continuation or rejection of the contract should be payable as an administrative expense:

- (a) If the counterparty has performed the contract the amount of the administrative expense should be the contractual price of the performance; or
- (b) If the insolvency representative uses assets owned by a third party that are in the possession of the debtor subject to contract, that party should be protected against diminution of the value of those assets and have an administrative claim in accordance with subparagraph (a).

Avoidance of security interests

(88) The insolvency law should specify that notwithstanding that a security interest is effective and enforceable under law other than the insolvency law, it may be subject to the avoidance provisions of insolvency law on the same grounds as other transactions.

Financial contracts

(103) Once the financial contracts of the debtor have been terminated, the insolvency law should permit counterparties to enforce and apply their security interest to obligations arising out of financial contracts. Financial contracts should be exempt from any stay under the insolvency law that applies to the enforcement of a security interest.

Participation by creditors

(126) The insolvency law should specify that creditors, both secured and unsecured, are entitled to participate in insolvency proceedings and identify what that participation may involve in terms of the functions that may be performed.

¹⁹ Provided the automatic stay on commencement of proceedings applies to prevent termination (pursuant to an automatic termination clause) of contracts with the debtor, all contracts should remain in place to enable the insolvency representative to consider the possibility of continuation, unless the contract has a termination date that happens to fall after the commencement of insolvency proceedings.

Right to be heard and to request review

(137) The insolvency law should specify that a party in interest has a right to be heard on any issue in the insolvency proceedings that affects its rights, obligations or interests. For example, a party in interest should be entitled:

- (a) To object to any act that requires court approval;
- (b) To request review by the court of any act for which court approval was not required or not requested; and
- (c) To request any relief available to it in insolvency proceedings.

Right of appeal²⁰

(138) The insolvency law should specify that a party in interest may appeal from any order of the court in the insolvency proceedings that affects its rights, obligations or interests.

*Reorganization plan**Approval by classes*

(150) Where voting on approval of the plan is conducted by reference to classes, the insolvency law should specify how the vote achieved in each class would be treated for the purposes of approval of the plan. Different approaches may be taken, including requiring approval by all classes or approval by a specified majority of the classes, but at least one class of creditors whose rights are modified or affected by the plan must approve the plan.

(151) Where the insolvency law does not require a plan to be approved by all classes, the insolvency law should address the treatment of those classes which do not vote to approve a plan that is otherwise approved by the requisite classes. That treatment should be consistent with the grounds set forth in recommendation 152.

Confirmation of an approved plan

(152) Where the insolvency law requires court confirmation of an approved plan, the insolvency law should require the court to confirm the plan if the following conditions are satisfied:

- (a) The requisite approvals have been obtained and the approval process was properly conducted;
- (b) Creditors will receive at least as much under the plan as they would have received in liquidation, unless they have specifically agreed to receive lesser treatment;
- (c) The plan does not contain provisions contrary to law;
- (d) Administrative claims and expenses will be paid in full, except to the extent that the holder of the claim or expense agrees to different treatment; and

²⁰ In accordance with the key objectives, the insolvency law should provide that appeals in insolvency proceedings should not have suspensive effect unless otherwise determined by the court, in order to ensure that insolvency can be addressed and resolved in an orderly, quick and efficient manner without undue disruption. Time limits for appeal should be in accordance with generally applicable law, but in insolvency need to be shorter than otherwise to avoid interrupting insolvency proceedings.

(e) Except to the extent that affected classes of creditors have agreed otherwise, if a class of creditors has voted against the plan, that class shall receive under the plan full recognition of its ranking under the insolvency law and the distribution to that class under the plan should conform to that ranking.

Challenges to approval (where there is no requirement for confirmation)

(153) Where a plan becomes binding on approval by creditors, without requiring confirmation by the court, the insolvency law should permit parties in interest, including the debtor, to challenge the approval of the plan. The insolvency law should specify criteria against which a challenge can be assessed, which should include:

- (a) Whether the grounds set forth in recommendation 152 are satisfied; and
- (b) Fraud, in which case the requirements of recommendation 154 should apply.

Secured claims

(172) The insolvency law should specify whether secured creditors are required to submit claims.

Valuation of secured claims

(179) The insolvency law should provide that the insolvency representative may determine the portion of a secured creditor's claim that is secured and the portion that is unsecured by valuing the encumbered asset.

Priority of claims

Secured claims

(188) The insolvency law should specify that secured claims should be satisfied from the encumbered asset in liquidation or pursuant to a reorganization plan, subject to claims that are superior in priority to the secured claim, if any. Claims superior in priority to secured claims should be minimized and clearly set forth in the insolvency law. To the extent that the value of the encumbered asset is insufficient to satisfy the secured creditor's claim, the secured creditor may participate as an ordinary unsecured creditor.

B. Additional insolvency recommendations of the guide on secured transactions

Law applicable to security rights in insolvency proceedings

173. The insolvency law should provide, as set out in recommendation 30 of the *UNCITRAL Legislative Guide on Insolvency Law*, that, notwithstanding the commencement of insolvency proceedings, the creation, effectiveness against third parties, priority and enforcement of a security right are governed by the law that would be applicable in the absence of the insolvency proceedings. However, this recommendation does not affect the application of the insolvency law of the State in which insolvency proceedings are commenced (*lex fori concursus*) on matters such as avoidance, treatment of secured creditors, ranking of claims or distribution of proceeds, as provided in recommendation 31 of the *UNCITRAL Insolvency Guide*.

[Note to the Commission: The Commission may wish to note that recommendation 174 is included in this chapter and not in the chapter on acquisition financing rights to ensure that all insolvency-related issues are addressed in the chapter on insolvency. There are three versions of recommendation 174, one for the unitary approach and two for the non-unitary approach (one with and the other without functional equivalence.)]

Assets subject to an acquisition security right (unitary approach)

174. The insolvency law should provide that, in the case of insolvency proceedings with respect to the debtor, assets subject to an acquisition security right are treated in the same way as assets subject to security rights generally.

Assets subject to an acquisition financing right (non unitary approach)

Alternative A

174. The insolvency law should provide that, in the case of insolvency proceedings with respect to the debtor, assets subject to an acquisition financing right are treated in the same way as assets subject to security rights generally.

Alternative B

174. The insolvency law should provide that, in the case of insolvency proceedings with respect to the debtor, assets subject to an acquisition financing right are treated as third-party-owned assets as provided in the *UNCITRAL Insolvency Guide*.

Receivables subject to an outright transfer before commencement

175. The insolvency law should provide that, if the debtor makes an outright transfer of a receivable before the commencement of the debtor's insolvency proceedings, the receivable is treated in the same way that the insolvency law would treat an asset that has been the subject of an outright transfer by the debtor before commencement. Like a pre-commencement transfer by the debtor of any other asset, the outright transfer of the receivable would be subject to any relevant avoidance rules of the insolvency law.

Assets acquired after commencement

176. Except as provided in recommendation 177, the insolvency law should provide that an asset of the estate acquired after the commencement of insolvency proceedings is not subject to a security right created by the debtor before the commencement of the insolvency proceeding.

177. The insolvency law should provide that an asset of the estate acquired after the commencement of insolvency proceedings with respect to the debtor is subject to a security right created by the debtor before the commencement of the insolvency proceedings to the extent the asset is proceeds (whether cash or non-cash) of an encumbered asset that was an asset of the debtor before commencement.

Automatic termination clauses in insolvency proceedings

178. If the insolvency law provides that a contract clause that, upon the commencement of insolvency proceedings or the occurrence of another insolvency-related event, automatically terminates any obligation under a contract or accelerates the maturity of any obligation under a contract, is unenforceable as

against the insolvency representative or the debtor, the insolvency law should also provide that such provision does not render unenforceable or invalidate a contract clause relieving a creditor from an obligation to make a loan or otherwise extend credit or other financial accommodations to the benefit of the debtor.

Third-party effectiveness of a security right in insolvency proceedings

179. The insolvency law should provide that, if a security right is effective against third parties at the time of the commencement of insolvency proceedings, action may be taken after the commencement of the insolvency proceedings to continue, preserve or maintain the effectiveness against third parties of the security right to the extent and in the manner permitted under the secured transactions law.

Priority of a security right in insolvency proceedings

180. The insolvency law should provide that, if a security right is entitled to priority under law other than insolvency law, the priority continues unimpaired in insolvency proceedings except if, pursuant to insolvency law, another claim is given priority. Such exceptions should be minimal and clearly set forth in the insolvency law. This recommendation is subject to recommendation 188 of the *UNCITRAL Insolvency Guide*.

Effect of a subordination agreement in insolvency proceedings

181. The insolvency law should provide that, if a holder of a security right in an asset of the insolvency estate subordinates its priority unilaterally or by agreement in favour of any existing or future competing claimant, such subordination is binding in insolvency proceedings with respect to the debtor.

Costs and expenses of maintaining value of the encumbered asset in insolvency proceedings

182. The insolvency law should provide that the insolvency representative is entitled to recover on a first priority basis from the value of an encumbered asset reasonable costs and expenses (including overhead as appropriate) incurred by the insolvency representative in maintaining, preserving or increasing the value of the encumbered asset for the benefit of the secured creditor.

Valuation of encumbered assets in reorganization proceedings

183. The insolvency law should provide that, in determining the liquidation value of encumbered assets in reorganization proceedings, consideration should be given to the use of those assets and the purpose of the valuation. The liquidation value of those assets may be based on their value as part of a going concern.

XII. Acquisition financing rights

[Note to the Commission: The Commission may wish to note that this chapter contains two parallel sets of recommendations, one set for States that wish to enact a unitary approach to security rights and an alternative set for States that wish to adopt a non-unitary approach. To maintain a parallel numbering with the non-unitary approach recommendations, certain recommendations in the context of the

unitary approach were retained although they repeat general rules and may thus be redundant (see recommendations 185, 186, 188 and 197).]

A. Unitary approach to acquisition security rights

Purpose

The purpose of the provisions of the law on acquisition security rights is:

- (a) To recognize the importance and facilitate the use of acquisition financing as a source of affordable credit, in particular for small- and medium-sized businesses;
- (b) To provide for equal treatment of all providers of acquisition financing; and
- (c) To facilitate secured transactions in general by creating transparency with respect to acquisition security rights.

Equivalence of an acquisition security right to a security right

184. The law should provide that an acquisition security right is a security right under this law. Thus, the provisions of this law governing security rights generally, as supplemented by the specific provisions of this law on acquisition security rights, should apply equally to all acquisition security rights.

Creation of an acquisition security right

185. The law should provide that an acquisition security right is created in the same way as a security right under recommendations 12-14.

Effectiveness of an acquisition security right against third parties

186. Except as otherwise provided in recommendation 187, the law should provide that an acquisition security right becomes effective against third parties in the same manner as provided in the provisions of this law governing third-party effectiveness with respect to security rights in the same type of encumbered asset.

Exception to the requirement of registration with respect to an acquisition security right in consumer goods

187. The law should provide that an acquisition security right in consumer goods is made effective against third parties upon its creation.

Applicability of general priority rules to acquisition security rights

188. The law should provide that, except as provided in recommendations 189-195, 198 and 199, the general provisions of this law on priority apply to acquisition security rights.

Priority of an acquisition security right in tangible property other than inventory or consumer goods as against an earlier registered non-acquisition security right in the same tangible property

189. The law should provide that, except as provided in recommendation 193, an acquisition security right in tangible property other than inventory or consumer

goods has priority as against a non-acquisition security right in the same tangible property created by the grantor (even if a notice of that security right was registered in the general security rights registry before registration of a notice of the acquisition security right), provided that:

(a) The acquisition secured creditor retains possession of the tangible property; or

(b) A notice relating to the acquisition security right is registered not later than [specify a short time period, such as 20 or 30 days] after the delivery of the tangible property to the grantor.

Priority of an acquisition security right in consumer goods as against an earlier registered non-acquisition security right in the same goods

190. The law should provide that, except as provided in recommendation 193, an acquisition security right in consumer goods has priority as against a non-acquisition security right in the same goods created by the grantor.

Priority between competing acquisition security rights in the same encumbered assets

191. The law should provide that an acquisition security right of a supplier of encumbered assets that has been made effective against third parties within the period specified in recommendation 189, subparagraph (b), has priority as against any other acquisition security right in the same encumbered assets.

Priority of an acquisition security right in inventory as against an earlier registered non-acquisition security right in inventory of the same kind

192. The law should provide that, except as provided in recommendation 193, an acquisition security right in inventory of the grantor has priority as against a non-acquisition security right in the grantor's inventory of the same kind (even if that security right became effective against third parties before the acquisition security right became effective against third parties), provided that:

(a) The acquisition secured creditor retains possession of the inventory; or

(b) Before delivery of the inventory to the grantor:

(i) A notice relating to the acquisition security right is registered in the general security rights registry; and

(ii) The holder of the earlier registered security right is notified in writing by the acquisition secured creditor that the acquisition secured creditor intends to enter into one or more acquisition financing transactions with respect to the inventory described in the notification. The notification should describe the inventory sufficiently to inform the holder of the earlier-registered security right of the inventory, the acquisition of which is being financed.

193. The law should provide that the priority provided under the rule in recommendation 189, 190 or 192 does not override the priority under recommendation 83 (specialized registration).

Priority of an acquisition security right as against the right of a judgement creditor

194. The law should provide that, notwithstanding recommendation 90, an acquisition security right that is made effective against third parties within the period provided in recommendation 189, subparagraph (b), has priority as against the rights of an unsecured creditor that, before the security right was made effective against third parties, under law other than this law:

(a) Obtained a judgement or provisional court order against a grantor after the creation of the acquisition security right; and

(b) Took the steps necessary to acquire rights in encumbered assets of the grantor by reason of the judgement or provisional court order.

Priority of an acquisition security right in an attachment to immovable property as against an earlier registered encumbrance in the immovable property

195. The law should provide that an acquisition security right in tangible property that is to become an attachment to immovable property, registered in the immovable property registry within [specify a short time period, such as 20-30 days] days after the tangible property became an attachment, has priority as against an existing encumbrance in the related immovable property (other than an encumbrance securing a loan financing the construction of the immovable property).

One notification or notice sufficient for one or more acquisition financing transactions between the same parties

196. The law should provide that a single notification to holders of earlier registered non-acquisition security rights pursuant to recommendation 192, subparagraph (b)(ii), may cover encumbered assets acquired through one or more acquisition financing transactions between the same parties, without those transactions having to be identified in the notification. However, the notification should be effective only for acquisition security rights in tangible property delivered within a period of [specify time, such as five years] years after the notification is given.

197. The law should provide that, as provided in recommendation 66, registration of a single notice is sufficient to ensure the third-party effectiveness of an acquisition security right created or to be created by all acquisition financing transactions entered into between the same parties to the extent they cover tangible property that falls within the description contained in the notice.

Priority of an acquisition security right in proceeds of tangible property other than inventory or consumer goods

198. The law should provide that the priority provided under recommendation 189 for an acquisition security right in tangible property other than inventory or consumer goods as against an earlier registered non-acquisition security right in the same tangible property extends to the proceeds of such property (including proceeds of proceeds).

Priority of an acquisition security right in proceeds of inventory

199. The law should provide that the priority provided under recommendation 192 for an acquisition security right in inventory as against an earlier registered security right in inventory of the same kind extends to the proceeds of such inventory other than receivables [, negotiable instruments, funds credited in a bank account and the obligation to pay under an independent undertaking] (including proceeds of proceeds). However, the acquisition secured creditor must notify earlier registered financiers with a security right in assets of the same kind as the proceeds before the time the proceeds arise.

[Note to the Commission: The Commission may wish to note that the priority conflict addressed here is between an inventory acquisition financier claiming a right in the receivables as proceeds of inventory and a receivables financier claiming the receivables as original encumbered assets (if the receivable is paid with a cheque, both are claiming a right in the cheque as proceeds). The Commission may wish to consider that, for the same policy reasons receivables are excluded from the super-priority in this recommendation, other proceeds of inventory consisting of rights to payment such as negotiable instruments, funds credited in a bank account and obligations to pay under an independent undertaking, should also be excluded. If the Commission decides to exclude all those types of proceeds, it may wish to consider whether this recommendation should be reformulated to provide that the super-priority of an acquisition security right does not extend to proceeds of inventory. This result would be in line with the approach taken in most legal systems. In that case, the Commission may wish to delete the second sentence of this recommendation.]

Enforcement of an acquisition security right

200. The law should provide that the provisions of the law on post-default rights apply to the enforcement of an acquisition security right.

Law applicable to acquisition security rights

201. The law should provide that the provisions of this law on private international law apply to acquisition security rights.

B. Non-unitary approach to acquisition financing rights

Purpose (non-unitary approach)

The purpose of the provisions of the law on acquisition financing rights (including, inter alia, retention-of-title and financial leases) is:

(a) To recognize the importance and facilitate the use of acquisition financing rights as a source of affordable credit, in particular for small- and medium-sized businesses;

(b) To provide for equal treatment of all acquisition financiers in the same manner as acquisition secured creditors, and to apply to acquisition financing rights rules that produce outcomes that are functionally equivalent to the outcomes produced by an acquisition security right regime in a unitary approach; and

(c) To facilitate secured transactions in general by creating transparency with respect to acquisition financing rights.

Equivalence of an acquisition financing right to an acquisition security right

184. The rules governing different types of acquisition financing rights should bring about economic results that are functionally equivalent to each other and, as more fully provided in recommendations 185-201, these economic results should be functionally equivalent to those brought about by the rules applicable to acquisition security rights.

Creation of an acquisition financing right

185. The law should provide that an acquisition financing right is created by an agreement between the acquisition financing transferee and the acquisition financier, which, before the delivery of the tangible property to the acquisition financing transferee, is concluded in or evidenced by a writing indicating the intent of the acquisition financier to have an acquisition financing right.

185bis. The law should provide that, notwithstanding the existence of an acquisition financing right, an acquisition financing transferee has the power to grant a security right in the tangible property subject to the acquisition financing right.

Effectiveness of an acquisition financing right against third parties

186. Except as otherwise provided in recommendation 193, the law should provide that an acquisition financing right is made effective against third parties by registration of a notice relating to the right in the general security rights registry or any appropriate specialized registry in the same manner as provided in the provisions of this law governing third-party effectiveness with respect to security rights in the same type of encumbered asset.

Exception to the requirement of registration with respect to an acquisition financing right in consumer goods

187. The law should provide that an acquisition financing right relating to consumer goods is effective against third parties upon its creation.

Applicability of general priority rules to acquisition financing rights

188. The law should provide that, except as provided in recommendations 189-195, 198 and 199, the general priority rules in recommendations [to be specified] apply not only under the unitary approach but also apply to acquisition financing rights under the non-unitary approach.

Priority of an acquisition financing right in tangible property other than inventory or consumer goods as against an earlier registered non-acquisition security right in the same tangible property

189. The law should provide that, except as provided in recommendation 193, an acquisition financing right in tangible property other than inventory or consumer goods has priority as against a non-acquisition security right in the same tangible property created by the acquisition financing transferee (even if a notice relating to that security right was registered in the general security rights registry before registration of a notice relating to the acquisition financing right), provided that:

- (a) The acquisition financier retains possession of the tangible property; or

(b) A notice relating to the acquisition financing right is registered not later than [specify a short time period, such as 20 or 30 days] days after delivery of the tangible property to the acquisition financing transferee.

Priority of an acquisition financing right in consumer goods as against an earlier registered non-acquisition security right in the same goods

190. The law should provide that, except as provided in recommendation 193, an acquisition financing right in consumer goods has priority as against a non-acquisition security right in the same goods created by the acquisition financing transferee.

Priority between competing acquisition financing rights in the same encumbered assets

191. The law should provide that an acquisition financing right or acquisition security right of a supplier of tangible property that has been made effective against third parties within the period specified in recommendation 189, subparagraph (b), has priority as against any other acquisition financing right or acquisition security right.

[Note to the Commission: The Commission may wish to note that the priority rule in this recommendation assumes that this guide contains an explicit recommendation that secured lenders that finance the acquisition of tangible property in the non-unitary system should have a super-priority as against prior general secured creditors equivalent to that enjoyed by suppliers in the non-unitary system based on their retained ownership under retention-of-title and financial lease transactions. Such a recommendation could be along the following lines:

“The law should provide that, in a non-unitary system, a lender may acquire an acquisition security right or an acquisition financing right through an assignment of the secured obligation from a supplier. If the lender acquires an acquisition security right, the rules applicable to acquisition security rights in a unitary system apply to that acquisition security right. If the lender acquires an acquisition financing right, the rules applicable to acquisition financing rights in a non-unitary system apply.”

The Commission may wish to consider whether such super-priority of acquisition secured creditors would be compatible with the concept of a non-unitary system. If incompatible, recommendation 191 should be deleted as unnecessary along with subparagraph (b) of the purpose section. If compatible, such an explicit recommendation should be added. The Commission may also wish to consider whether another recommendation enabling suppliers to take an acquisition security right should also be included. In such a case, suppliers would be treated in the same way as secured creditors and a non-unitary approach may not be necessary.]

Priority of an acquisition financing right in inventory as against an earlier registered non-acquisition security right in inventory of the same kind

192. The law should provide that, except as provided in recommendation 193, an acquisition financing right in inventory of the acquisition financing transferee has priority as against a non-acquisition security right in the acquisition financing transferee’s inventory of the same kind (even if that right became effective against third parties before the acquisition financing right was made effective against third parties), provided that:

- (a) The acquisition financier retains possession of the inventory; or

- (b) Before delivery of the inventory to the acquisition financing transferee:
 - (i) A notice relating to the acquisition financing right is registered in the general security rights registry; and
 - (ii) The holder of an earlier registered non-acquisition security right is notified in writing that the acquisition financier intends to enter into one or more acquisition financing with respect to the inventory. The notification should describe the inventory sufficiently to inform the holder of an earlier registered non-acquisition security right of the inventory, the acquisition of which is being financed.

Application of priority rules in the case of specialized registration

193. The law should provide that the priority provided under the rule in recommendation 189, 190 or 192 does not override the priority provided under recommendation 83 (specialized registration).

Priority of an acquisition financing right as against the right of a judgement creditor

194. The law should provide that, notwithstanding recommendation 90, an acquisition financing right that is made effective against third parties within the period specified in recommendation 189, subparagraph (b), has priority as against the rights of an unsecured creditor that, before the acquisition financing was made effective against third parties, under law other than this law:

- (a) Obtained a judgement against an acquisition financing transferee after the creation of the acquisition financing right; and
- (b) Took the steps necessary to acquire rights in the relevant assets of the acquisition financing transferee by reason of the judgement.

Priority of an acquisition financing right in an attachment to immovable property as against earlier registered encumbrance in the immovable property

195. The law should provide that an acquisition financing right in tangible property that is to become attachments to immovable property, registered in the immovable property registry within [specify a short time period, such as 20-30 days] days after the tangible property became attachments, has priority as against an existing encumbrance in the related immovable property (other than an encumbrance securing a loan financing the construction of the immovable property).

One notification or notice sufficient for one or more acquisition financing transactions between the same parties

196. The law should provide that a single notification to holders of earlier registered non-acquisition security rights pursuant to recommendation 192, subparagraph (b)(ii), may cover goods transferred through one or more acquisition financing transactions between the same parties and individual transactions need not be identified in the notification. However, the notification should be effective only for acquisition financing rights in tangible property delivered within a period of [specify time, such as five years] years after the notification is given.

197. The law should provide that, as provided in recommendation 66, registration of a single notice is sufficient to ensure the third-party effectiveness of an

acquisition financing right created or to be created by all acquisition financing transactions entered into between the same parties to the extent they cover tangible property that falls within the description contained in the notice.

Priority of an acquisition financing right in proceeds of tangible property other than inventory or consumer goods

198. The law should provide that the priority provided under recommendation 189 for an acquisition financing right in tangible property other than inventory or consumer goods extends to the proceeds of such property (including proceeds of proceeds).

Priority of an acquisition financing right in proceeds of inventory

199. The law should provide that the priority of an acquisition financing right in inventory provided under recommendation 192 extends to the proceeds of such inventory, other than proceeds of inventory in the form of receivables [, negotiable instruments, funds credited in a bank account and the obligation to pay under an independent undertaking] (including proceeds of proceeds). However, the acquisition financier must notify earlier-registered secured creditors with a security right in assets of the same kind as the proceeds before the proceeds arise.

Post-default rights relating to an acquisition financing right

200. The law should provide rules for the post-default enforcement of acquisition financing rights that deal with:

- (a) The manner in which the acquisition financier may obtain possession of the encumbered assets;
- (b) Whether the acquisition financier may be required to dispose of the encumbered assets and, if so, how;
- (c) Whether the acquisition financier seller may retain any surplus; and
- (d) Whether the acquisition financier may pursue the acquisition transferee for any deficiency.

200 bis. The law should provide, with respect to post-default rights relating to an acquisition financing right, that:

- (a) The same principles and objectives indicated in the provisions of the law with respect to post-default rights relating to security rights are applicable even if the rules implementing those principles and objectives in the context of acquisition financing rights differ; and
- (b) In seeking to provide for functionally equivalent results, the provisions on post-default rights relating to an acquisition financing right under a current regime be modified to produce congruity with the provisions of the law on security rights to the greatest extent possible, and any divergences in the provisions on post-default rights be permitted only to the extent necessary to preserve the coherence of the ownership regime.

200 tres. The law should provide that post-default rights relating to an acquisition security right are governed by rules that, subject to recommendation 200bis, subparagraph (b), produce results functionally equivalent to the results produced by the provisions of the law governing post-default rights relating to an acquisition financing right.

Law applicable to acquisition financing rights

201. The law should provide that the provisions of this law on private international law apply to acquisition financing rights.

XIII. Private international law^{*}**Purpose**

The purpose of private international law rules is to determine the law applicable to each of the following issues: the creation of a security right; the pre-default rights and obligations between the secured creditor and the grantor; the effectiveness of a security right against third parties; the priority of a security right as against the rights of competing claimants; and the enforcement of a security right.

A. General recommendations**Law applicable to a security right in tangible property**

202. The law should provide that, except as otherwise provided in recommendations 203 and 207, the creation, the effectiveness against third parties and the priority as against the rights of competing claimants of a security right in tangible property are governed by the law of the State in which the encumbered asset is located. However, with respect to security rights in tangible property of a type ordinarily used in more than one State, the law should provide that such issues are governed by the law of the State in which the grantor is located. [With respect to security rights in the type of tangible property mentioned in the preceding sentence that is subject to a specialized registration or title certificate system, the law should provide that such issues are governed by the law of the State under the authority of which the registry is maintained or the title certificate is issued, if the registry provides for registration of security rights or notation of security rights on the title certificate is permitted.]

[Note to the Commission: The Commission may wish to consider whether a recommendation should be added to provide explicitly that the law of the location of the document should apply to a priority conflict between a secured creditor with a possessory security right in a negotiable document and a secured creditor with a non-possessory security right in the goods covered by a document.]

Law applicable to a security right in goods in transit and export goods

203. The law should provide that a security right in tangible property (other than negotiable instruments or negotiable documents) in transit or to be exported from the State in which it is located at the time of the creation of the security right may be created and made effective against third parties under the law of the State of the initial location of the property as provided in recommendation 202 or under the law of the State of its ultimate destination, provided that the property reaches that State within a short time period of [to be specified] days after the time of creation of the security right.

^{*} The recommendations on private international law were prepared in close cooperation with the Hague Conference on Private International Law.

Law applicable to a security right in intangible property

204. The law should provide that the creation, the effectiveness against third parties and the priority as against the rights of competing claimants of a security right in intangible property are governed by the law of the State in which the grantor is located.

Law applicable to receivables arising from a sale, lease or security agreement relating to immovable property

205. The law should provide that the law of the State in which the assignor is located governs the creation, third-party effectiveness and priority of a security right in a receivable arising from a sale, lease or security agreement relating to immovable property as against the rights of competing claimants. However, a priority conflict involving the rights of a competing third party registered in the immovable property registry of the State in which the immovable property is located is governed by the law of that State.

[Note to the Commission: The Commission may wish to confine the scope of recommendation 205 to instances where the law of the State of the registry attaches some priority effects to the registration of the rights of a competing claimant. The law of the grantor should continue to apply if registration in the land registry is irrelevant for priority issues.]

Law applicable to a security right in a right to payment of funds credited to a bank account

206. Except as otherwise provided in recommendation 207, the law should provide that the creation, the effectiveness against third parties, the priority as against the rights of competing claimants, the rights and duties of the depositary bank with respect to the security right and the enforcement of the security right in a right to payment of funds credited to a bank account are governed by

Alternative A

the law of the State in which the bank that maintains the bank account has its place of business. If the bank has places of business in more than one State, reference should be made to the place where the branch maintaining the account is located.

Alternative B

the law of the State expressly stated in the account agreement as the State whose law governs the account agreement or, if the account agreement expressly provides that another law is applicable to all such issues, that other law. However, the law of the State determined pursuant to the preceding sentence applies only if the depositary bank has, at the time of the conclusion of the account agreement, an office in that State that is engaged in the regular activity of maintaining bank accounts. If the applicable law is not determined pursuant to the preceding two sentences, the applicable law is to be determined pursuant to default rules based on article 5 of the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary.

Law applicable to the third-party effectiveness of a security right in specified types of asset by registration

207. The law should provide that, if the State in which the grantor is located recognizes registration as a method of achieving effectiveness against third parties of a security right in a negotiable instrument or a right to payment of funds credited to a bank account, the law of the State in which the grantor is located determines whether the effectiveness against third parties of a security right in such encumbered asset has been achieved by registration under the laws of that State.

Law applicable to a security right in proceeds under an independent undertaking

208. The law should provide that the law of the State specified in the independent undertaking of the guarantor/issuer, confirmer or nominated person governs:

(a) The rights and duties of the guarantor/issuer, confirmer or nominated person that has received a request for an acknowledgement or that has or may pay or otherwise give value under an independent undertaking;

(b) The right to enforce a security right in proceeds under an independent undertaking against a guarantor/issuer, confirmer or nominated person; and

(c) Except to the extent otherwise provided in recommendation 210, the effectiveness against third parties and the priority as against the rights of competing claimants of a security right in proceeds under the independent undertaking.

209. If the applicable law is not specified in the independent undertaking of the guarantor/issuer or confirmer, the law governing the matters referred to in recommendation 208 is the law of the State of the location of the branch or office of the guarantor/issuer or confirmer indicated in the independent undertaking. However, in the case of a nominated person, the applicable law is the law of the State of the location of the nominated person's branch or office that has or may pay or otherwise give value under the independent undertaking.

210. The law should provide that, if a security right in proceeds under an independent undertaking is created and is made effective against third parties automatically as a result of the creation and third-party effectiveness of a right in a receivable, negotiable instrument or other intangible asset, the payment or other performance of which the independent undertaking secures, the creation and the third-party effectiveness of the security right in the proceeds under the independent undertaking is governed by the law of the State whose law governs the creation and the third-party effectiveness of the right in the receivable, negotiable instrument or other intangible asset.

Law applicable to a security right in proceeds

211. The law should provide that:

(a) The creation of a security right in proceeds is governed by the law of the State whose law governs the creation of the security right in the original encumbered asset from which the proceeds arose; and

(b) The effectiveness against third parties and the priority as against the rights of competing claimants of a security right in proceeds are governed by the same law as the law of the State whose law governs the effectiveness against third parties and the priority as against the rights of competing claimants of a security right in original encumbered assets of the same kind as the proceeds.

Law applicable to the rights and obligations of the grantor and the secured creditor

212. The law should provide that the mutual rights and obligations of the grantor and the secured creditor with respect to the security right, whether arising from the security agreement or by law, are governed by the law chosen by them and, in the absence of a choice of law, by the law governing the security agreement.

Law applicable to the rights and obligations of third-party obligors and secured creditors

213. The law should provide that the following matters are governed by the law of the State whose law governs a receivable, negotiable instrument or negotiable document:

(a) The relationship between the debtor of the receivable and the assignee of the receivable, between an obligor under a negotiable instrument and the holder of a security right in the instrument or between the issuer of a negotiable document and the holder of a security right in the document;

(b) The conditions under which the assignment of the receivable, a security right in the negotiable instrument or a security right in the negotiable document may be invoked against the debtor of the receivable, the obligor on the negotiable instrument or the issuer of the negotiable document (including whether an anti-assignment agreement may be asserted by the debtor of the receivable, the obligor or the issuer); and

(c) The determination of whether the obligations of the debtor of the receivable, the obligor on the negotiable instrument or the issuer of the negotiable document have been discharged.

Law applicable to the enforcement of a security right

214. The law should provide that matters affecting the enforcement of a security right:

(a) In tangible property are governed by the law of the State where enforcement takes place; and

(b) In intangible property are governed by the law of the State whose law governs the priority of a security right.

This recommendation is subject to recommendation 173 on the law applicable to security rights in insolvency proceedings.

[Note to the Commission: The Commission may wish to consider whether enforcement of security rights in both tangible and intangible property should be referred to the law governing priority. The place of enforcement of security rights in tangible property in most instances would be the place of the location of the asset and the law of that State would govern priority. Similarly, enforcement of a security right in intangible property would take place in the State of the location of the grantor and the law of that State would govern priority.]

Meaning of “location” of the grantor

215. The law should provide that, for the purposes of the provisions of this law on private international law, the grantor is located in the State in which it has its place of business. If the grantor has a place of business in more than one State, the

grantor's place of business is that place where the central administration of the grantor is exercised. If the grantor does not have a place of business, reference is to be made to the habitual residence of the grantor.

Relevant time when determining location

216. The law should provide that:

(a) Except as provided in subparagraph (b) of this recommendation, references to the location of the assets or of the grantor in the provisions of this law on private international law refer, for creation issues, to that location at the time of the creation of the security right and, for third-party effectiveness and priority issues, to that location at the time the issue arises;

(b) If all rights of competing claimants in an encumbered asset were created and made effective against third parties before a change in location of the asset or the grantor, references in the provisions of this law on private international law to the location of the asset or of the grantor (as relevant under the recommendations in this chapter) refer, with respect to third-party effectiveness and priority issues, to the location prior to the change in location.

Exclusion of renvoi

217. The law should provide that the reference in the provisions of this law on private international law to "the law" of another State as the law governing an issue refers to the law in force in that State other than its private international law rules.

Public policy and internationally mandatory rules

218. The law should provide that:

(a) The application of the law determined under the provisions of this law on private international law may be refused by the forum only if the effects of its application would be manifestly contrary to the public policy of the forum;

(b) A forum may apply those provisions of its own law which, irrespective of rules of private international law, must be applied even to international situations; and

(c) The rules in subparagraphs (a) and (b) of this recommendation do not permit the application of provisions of the law of the forum to third-party effectiveness or priority of a security right as against the rights of competing claimants, unless the law of the forum is the applicable law under the provisions of this law on private international law.

B. Special rules when the applicable law is the law of a multi-unit State

219. The law should provide that in applying the recommendations in this chapter to situations in which the State whose law governs an issue is a multi-unit State:

(a) Subject to subparagraph (b) of this recommendation, references to the law of a multi-unit State are to the law of the relevant territorial unit (as determined on the basis of the location of the grantor or of an encumbered asset or otherwise under the recommendations in this chapter) and, to the extent applicable in that unit, to the law of the multi-unit State itself;

(b) If the law in force in a territorial unit of a multi-unit State designates the law of another territorial unit of that State to govern third-party effectiveness or priority, the law of that other territorial unit governs that issue.

220. The law should provide that if, under the provisions of the law on private international law, the applicable law is that of a multi-unit State or one of its territorial units, the internal choice of law rules in force in that multi-unit State determine whether the substantive rules of law of that multi-unit State or of a particular territorial unit of that multi-unit State apply.

[Note to the Commission: The Commission may wish to combine recommendations 219, subparagraph (b) and 220, as recommendation 219, subparagraph (b), is in substance covered by recommendation 220.]

221. The law should provide that, if the account holder and the depositary bank have agreed on the law of a specified territorial unit of a multi-unit State:

(a) The references to “State” in the first sentence of recommendation 206 (alternative B) are to that territorial unit;

(b) The references to “that State” in the second sentence of recommendation 206 (alternative B) are to the multi-unit State itself.

222. The law should provide that the law of a territorial unit applies if:

(a) Under recommendations 206 (alternative B) and 221, the designated law is that of a territorial unit of a multi-unit State;

(b) Under the law of that State the law of a territorial unit applies only if the depositary bank has an office within that territorial unit which satisfies the condition specified in the second sentence of recommendation 206 (alternative B); and

(c) The rule described in subparagraph (b) of this recommendation is in force at the time the security right in the bank account is created.

[Note to the Commission: The Commission may wish to note that recommendations 221 and 222, which track the language of article 12, paragraphs 1 and 4, of the Hague Convention on the Law Applicable to Certain Rights in respect of Securities held with an Intermediary respectively, may be necessary if the Commission decides to retain alternative B in recommendation 206.]

XIV. Transition

Purpose

The purpose of the provisions of the law on transition is to provide a fair and efficient transition from the regime before the enactment of the law to the regime after the enactment of the law.

Effective date

223. The law should specify either a date subsequent to its enactment, as of which it will enter into force (the “effective date”) or a mechanism by which the effective date may be specified.

Inapplicability of the law to matters in litigation or subject to enforcement

224. The law should provide that it does not apply to matters that, at the effective date, are subject to litigation (or a comparable dispute resolution system). If enforcement of a security right has commenced before the effective date, the enforcement may continue under the law in effect immediately before the effective date.

Creation of a security right

225. The law should provide that the existence of a security right created under the law in effect immediately before the effective date is determined by that law.

Third-party effectiveness of a security right

226. The law should provide that a security right made effective against third parties under the law in effect immediately before the effective date remains effective against third parties until the earlier of the time it would cease to be effective against third parties under the law in effect immediately before the effective date and the expiration of a period of [specify length of the transition period] after the effective date (“the transition period”). If, during that time of third-party effectiveness or such longer period provided in recommendation 227, the secured creditor takes any steps necessary to ensure that the security right is made effective against third parties under this law, its effectiveness against third parties is continuous.

227. The law should provide that the time when the security right was made effective against third parties or became the subject of a registered notice, as applicable, is the time when such security right was made effective against third parties or became the subject of a registered notice under the law in effect immediately before the effective date. This rule applies for purposes of determining priority of a security right that was effective against third parties under the law in effect immediately before the effective date and is continuously effective against third parties under this law.

Priority of a security right

228. Subject to recommendations 229 and 230, the law should provide that the priority of a security right as against the right of a competing claimant is governed by this law.

229. The law should provide that the priority of a security right as against the right of a competing claimant is determined by the law in effect immediately before the effective date if:

(a) Both the security right and the right of the competing claimant are created before the effective date; and

(b) The status of neither right has changed since the effective date.

230. The status of a security right has changed if:

(a) It was effective against third parties on the effective date in accordance with recommendation 226 and later ceased to be effective against third parties; or

(b) It was not effective against third parties on the effective date and later became effective against third parties.

A/CN.9/631/Add.1 [Original: English]

**Note by the Secretariat on recommendations of the UNCITRAL draft
Legislative Guide on Secured Transactions, submitted to the Working
Group on Security Interests at its twelfth session**

ADDENDUM

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Introduction

A. Purpose of the Guide

1. The purpose of the UNCITRAL Legislative Guide on Secured Transactions (hereinafter referred to as “the Guide” or “this Guide”) is to assist States in the development of modern secured transactions (i.e. transactions creating a proprietary security right in movable property; for the definition of “secured transaction”, see para. 19 below) laws with a view to promoting the availability of secured credit. The Guide is intended to be useful to States that do not currently have efficient and effective secured transactions laws, as well as to States that already have workable laws but wish to review or modernize them, or to harmonize or coordinate their laws with those of other States.

2. The Guide is based on the premise that sound secured transactions laws can have significant economic benefits for States that adopt them, including attracting credit from domestic and foreign lenders and other credit providers, promoting the development and growth of domestic businesses (particularly small and medium-sized enterprises) and generally increasing trade. Such laws also benefit consumers by lowering prices for goods and services and making consumer credit more readily available. To be effective, such laws must be supported by efficient and effective judicial systems and other enforcement mechanisms. They must also be supported by insolvency laws that respect rights derived from secured transactions laws (see the *UNCITRAL Legislative Guide on Insolvency Law*).¹

3. The Guide seeks to rise above differences among legal regimes to offer pragmatic and proven solutions that can be accepted and implemented in States having divergent legal traditions. The focus of the Guide is on developing laws that achieve practical economic benefits for States that adopt them. While it is possible that States will have to incur predictable, though limited, costs to develop and implement these laws, substantial experience suggests that the resulting short- and long-term benefits to such States should greatly outweigh the costs.

4. All businesses, whether manufacturers, distributors, service providers or retailers, require working capital to operate, to grow and to compete successfully in the marketplace. It is well established, through studies conducted by such organizations as the International Bank for Reconstruction and Development (the World Bank), the International Monetary Fund, the Asian Development Bank and the European Bank for Reconstruction and Development (EBRD), that one of the most effective means of providing working capital to commercial enterprises is through secured credit.

5. The key to the effectiveness of secured credit is that it allows businesses to use the value inherent in their assets as a means of reducing risk for the creditor. Risk is reduced because credit secured by assets gives creditors access to the assets as another source of payment in the event of non-payment of the secured obligation. As the risk of non-payment is reduced, the availability of credit is likely to increase and the cost of credit is likely to fall.

6. A legal system that supports secured credit transactions is critical to reducing the perceived risks of credit transactions and promoting the availability of secured credit. Secured credit is more readily available to businesses in States that have

¹ United Nations publication, Sales No. E.05.V.10.

efficient and effective laws that provide for consistent, predictable outcomes for creditors in the event of non-performance by debtors. On the other hand, in States that do not have efficient and effective laws, where creditors perceive the legal risks associated with credit transactions to be high, the cost of credit normally increases, as creditors require increased compensation to evaluate and assume the increased risk. In some States, the absence of an efficient and effective secured transactions regime, or of an insolvency law regime, under which security rights are recognized, has resulted in the virtual elimination of credit for small and medium-sized commercial enterprises, as well as for consumers.

7. By aiding in the cultivation and growth of individual businesses, a legal regime that promotes secured credit can have a positive effect upon the general economic prosperity of a State. Thus, States that do not have an efficient and effective secured transactions regime may deny themselves valuable economic benefits.

8. In order to best promote the availability of secured credit, the Guide suggests that secured transactions laws should be structured to enable businesses to utilize the value inherent in their movable property to the maximum extent possible to obtain credit. In this regard, the Guide adopts two of the most essential concepts of successful secured transactions laws: the concepts of priority and effectiveness against third parties. The concept of priority allows for the concurrent existence of security rights having different priority status in the same assets. This makes it possible for a business to utilize the value of its assets to the maximum extent possible to obtain secured credit from more than one creditor using the same assets as security, while at the same time allowing each creditor to know the priority of its security right. The concept of the effectiveness of a security right against third parties, in the form of a system allowing, *inter alia*, the achievement of third-party effectiveness by registration of a simple notice in a quick and inexpensive way, is designed to promote legal certainty with regard to the relative priority status of rights of creditors and thus to reduce the risks and costs associated with secured transactions.

9. The legal regime envisaged in the Guide is a purely domestic regime. The Guide is addressed to national legislators considering reform of domestic secured transactions laws. However, because secured transactions often involve parties and assets located in different jurisdictions, the Guide also seeks to address the recognition of security rights and title-based security devices, such as retention of title in tangible property and financial leases, effectively created in other jurisdictions. This would represent a marked improvement for the holders of those rights over the laws currently in effect in many States, under which such rights often are lost once an encumbered asset is transported across national borders, and would go far towards encouraging creditors to extend credit in cross-border transactions, a result that could enhance international trade.

10. Throughout, the Guide seeks to establish a balance among the interests of debtors, creditors (whether secured, privileged or unsecured), affected third persons, such as buyers and other transferees of encumbered assets, and the State. In so doing, the Guide adopts the premise, supported by substantial empirical evidence, that all creditors will accept such a balanced approach and will thereby be encouraged to extend credit, as long as the laws (and supporting legal and governmental infrastructure) are effective to enable the creditors to assess their risks with a high level of predictability and with confidence that they will ultimately obtain the economic value of the encumbered assets in the event of non-payment by

the debtor. Essential to this balance is a close coordination between the secured transactions and insolvency law regimes, including provisions pertaining to the treatment of security rights in the event of a reorganization or liquidation of a business. Additionally, certain debtors, such as consumer debtors, require additional protections. Thus, although the regime envisioned by the Guide will apply to many forms of consumer transaction, it is not intended to override consumer-protection laws or to discuss consumer-protection policies, since these matters do not lend themselves to unification.

11. In the same spirit, the Guide also addresses concerns that have been expressed with respect to secured credit. One such concern is that providing a creditor with a priority claim to all or substantially all of a person's assets may appear to limit the ability of that person to obtain financing from other sources. Another concern is the potential ability of a secured creditor to exercise influence over a business, to the extent that the creditor may seize, or threaten seizure of, the encumbered assets of that business upon default. Yet another concern is that, in some cases, secured creditors may take most or all of a person's assets in the case of insolvency and leave little for unsecured creditors, who may not be in a position to bargain for a security right in those assets. The Guide discusses these concerns and, in those situations where the concerns appear to have merit, suggests balanced solutions.

12. The Guide builds on the work of UNCITRAL and other organizations. Such work includes the EBRD Model Law on Secured Transactions, completed in 1994; the EBRD "Core principles for a secured transactions law", completed in 1997; the Organization for Harmonization of Business Law in Africa Uniform Act Organizing Securities, prepared in 1997; the study on secured transactions law reform in Asia, prepared by the Asian Development Bank in 2000;² the United Nations Convention on the Assignment of Receivables in International Trade³ (the "United Nations Assignment Convention"), adopted in 2001; the Convention on International Interests in Mobile Equipment, adopted in 2001, and the relevant protocols thereto; the Convention on the Law Applicable to Certain Rights in respect of Securities held with an Intermediary, adopted by the Hague Conference on Private International Law in 2001; the Organization of American States (OAS) Model Inter-American Law on Secured Transactions, prepared in 2002; the *UNCITRAL Insolvency Guide*, completed in 2004; and the UNIDROIT preliminary draft convention on harmonized substantive rules regarding intermediated securities.

B. Terminology and rules of interpretation

13. The Guide adopts terminology to express the concepts that underlie an effective secured transactions regime. The terms used are not drawn from any particular legal system. Even when a term appears to be the same as that found in a particular national law, the Guide does not intend to adopt the meaning of the term in that national law. Rather, the Guide provides definitions giving a specific meaning to each key term. It is important to note that many definitions also have the effect of delimiting the scope of the recommendations in the Guide that use those terms. Some recommendations use terms that are defined in those recommendations and the meaning of some terms defined in this chapter is further elaborated in

² See *Law and Policy Reform at the Asian Development Bank 2000*, vol. I (Manila, Asian Development Bank, April 2000).

³ Ibid., Sales No. E.04.V.14.

recommendations that use those terms. Thus, the scope and content of each recommendation depend on the meaning of the defined terms used.

14. The Guide's approach of using defined terms is taken to facilitate precise communication, independent of any particular national legal system, and to enable readers of the Guide to understand its recommendations uniformly, providing them with a common vocabulary and conceptual framework. The definitions should be read with care and should be referred to whenever the defined terms are encountered.

15. While the terms are not of themselves an imperative element of the Guide's recommendations, legislation based on the Guide will typically include specific definitions for the terms that are used. Even if the terms used in the legislation differ from those used in the Guide, the definitions provided in the terminology might nevertheless be used. This would avoid unintended substantive change and would make most likely the uniform understanding of the terms used, from the outset, to maximize uniform interpretation immediately upon the effective date of the new legislation. Use of the terms and, more importantly, the definitions provided in the Guide will also encourage harmonization of the law governing security rights.

16. The word "or" is not intended to be exclusive; use of the singular also includes the plural and vice versa; "include" and "including" are not intended to indicate an exhaustive list; "may" indicates permission and "should" indicates instruction; and "such as" and "for example" are to be interpreted in the same manner as "include" or "including". "Creditors" should be interpreted as including both the creditors in the enacting State and foreign creditors, unless otherwise specified. References to "person" should be interpreted as including both natural and legal persons, unless otherwise specified.

17. Some States may choose to implement the recommendations of the Guide by enacting a single comprehensive statute (a method more likely to produce coherence and avoid errors of omission or misunderstanding), while other States may seek to modify their existing body of law by insertion of specific rules in various places. The Guide refers to the entire body of recommended rules, whichever method is chosen for implementation, as "the law" or "this law".

18. The Guide also uses the term "law" in various other contexts. Except when otherwise expressly provided, throughout the Guide (a) all references to law refer to both statutory and non-statutory law; (b) all references to law refer to internal law, excluding private international law rules (so as to avoid renvoi); (c) all references to "law other than the secured transactions law" refer to the entire body of a State's law (whether substantive or procedural) other than that embodying the law governing secured transactions (whether pre-existing or newly enacted or modified pursuant to the recommendations of the Guide); (d) all references to "the law governing negotiable instruments" refer not only to a special statute or body of law denominated as "negotiable instruments law" but include also all contract and other general law that might be applicable to transactions or situations involving a negotiable instrument (the same rule applies to similar expressions); and (e) all references to "insolvency law" are similarly all-encompassing, but refer only to law that might be applicable after the commencement of insolvency proceedings.

19. The following paragraphs identify the principal terms used and the core meaning given to them in the Guide. The meaning of these terms is further refined when they are used in subsequent chapters. Those chapters also define and use additional terms (as is the case, for example, with chapter XI on insolvency;

see A/CN.9/631/Add.8). The definitions should be read together with the relevant recommendations. The principal terms are defined as follows:

(a) “Acknowledgment” with respect to proceeds under an independent undertaking means that the guarantor/issuer, confirmer or nominated person that will pay or otherwise give value upon a draw under an independent undertaking has, unilaterally or by agreement:

(i) Acknowledged or consented to (however acknowledgement or consent is evidenced) the creation of a security right (whether denominated as an assignment or otherwise) in favour of the secured creditor in the proceeds under an independent undertaking; or

(ii) Has obligated itself to pay or give value to the secured creditor upon a demand for payment (“draw”) under an independent undertaking;

(b) “Acquisition financier”, a term used only in the context of the non-unitary approach to acquisition financing rights, means a person that has an acquisition financing right (and, thus, includes a retention-of-title seller, a financial lessor and the obligee under hire-purchase transactions, or a creditor under any other acquisition financing transaction and any other transaction described in subparagraphs (iii) and (iv) of definition (c));

(c) “Acquisition financing right”, a term used only in the context of the non-unitary approach to acquisition financing rights, means any of the following rights:

(i) A retention-of-title right;

(ii) The right of a lessor under a financial lease;

(iii) The retained ownership and related rights arising under any arrangement that enables a person to acquire possession or use of tangible property other than negotiable instruments or negotiable documents and whereby pursuant to the arrangement title to that property does not vest irrevocably in the person possessing or using the property until or under the condition that the price is paid; and

(iv) A right under any arrangement by which a creditor that has provided credit to enable a person to acquire possession or use of tangible property other than negotiable instruments or negotiable documents, reserves the right to become the irrevocable owner of the property in satisfaction of the repayment obligation;

(d) “Acquisition financing transferee”, a term used only in the context of the non-unitary approach to acquisition financing rights, means the person whose right to assets is subject to an acquisition financing right and, thus, includes a retention-of-title buyer, a financial lessee or a creditor under any other acquisition financing transaction;

(e) “Acquisition secured creditor”, in the context of both the unitary and the non-unitary approach to acquisition financing rights, means a secured creditor that has an acquisition security right and, in the context of a unitary approach, includes a retention-of-title seller, financial lessor, hire-purchase lessor or other acquisition financier;

(f) “Acquisition security right”, in the context of both the unitary and the non-unitary approach to acquisition financing rights, means a security right in tangible property other than negotiable instruments or negotiable documents that secures the obligation to pay any unpaid portion of the purchase price of the property or an obligation incurred or credit otherwise provided to enable the grantor to acquire the property. An acquisition security right need not be denominated as such. Under the unitary approach, the term includes a creditor’s rights in the property under a retention-of-title sale, hire-purchase transaction, financial lease or other acquisition financing transaction;

(g) “Assignee” means the person to which an assignment of a receivable is made;

(h) “Assignment” means the creation of a security right in a receivable and includes an outright transfer of a receivable. The creation of a security right in a receivable includes an outright transfer by way of security;

(i) “Assignor” means the person that makes an assignment of a receivable;

(j) “Attachment to immovable property” means tangible property that is so physically attached to immovable property that, despite the fact that it has not lost its separate identity, is treated as immovable property under the law of the State where the immovable property is located;

(k) “Attachment to movable property” means tangible property that is so physically attached to other tangible property that, despite the fact that it has not lost its separate identity, it is treated as part of that movable property under law other than this law;

(l) “Bank account” means an account that is maintained by a bank into which funds may be deposited or credited. The term includes a checking or other current account, as well as a savings or time deposit account. The term does not include a claim against the bank evidenced by a negotiable instrument;

The right to payment of funds credited to a bank account covers a right to the payment of funds transferred into an internal account of the bank and not applied to any obligations owed to the bank. Funds transferred to the bank by way of anticipated reimbursement of a future payment obligation that the bank has accepted in the ordinary course of its banking business is also covered to the extent that the person that gave the bank instructions has a claim to those funds if the bank does not make the future payment;

(m) “Competing claimant” means:

(i) Another secured creditor with a security right in the same encumbered asset (whether as an original encumbered asset or proceeds);

(ii) In the context of the non-unitary approach to acquisition financing rights, the seller, financial lessor or other acquisition financier of the same encumbered asset that has retained title to it;

(iii) Another creditor of the grantor that has a right in the same encumbered asset (e.g. by operation of law, attachment, seizure or similar process);

(iv) The insolvency representative in the insolvency of the grantor (in the chapter on insolvency, reference is made to “the insolvency of the debtor” for

reasons of consistency with the terminology used in the *UNCITRAL Legislative Guide on Insolvency Law*); or

(v) Any buyer or other transferee (including a lessee or licensee) of the encumbered asset;

(n) “Confirmer” means a bank or other person that adds its own independent undertaking to that of the guarantor/issuer;

In line with article 6, subparagraph (e), of the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit⁴ (the “United Nations Guarantee and Stand-by Convention”), a confirmation provides the beneficiary with the option of demanding payment from the confirmer in conformity with the terms and conditions of the confirmed independent undertaking instead of from the guarantor/issuer;

(o) “Consumer goods” means goods that the grantor uses or intends to use for personal, family or household purposes;

(p) “Control” with respect to proceeds under an independent undertaking exists:

(i) Automatically upon the creation of the security right if the guarantor/issuer, confirmer or nominated person is the secured creditor; or

(ii) If the guarantor/issuer, confirmer or nominated person has made an acknowledgment in favour of the secured creditor;

(q) “Control” with respect to a right to payment of funds credited to a bank account exists:

(i) Automatically upon the creation of a security right if the depositary bank is the secured creditor;

(ii) If the depositary bank has concluded a control agreement evidenced by an authenticated record with the grantor and the secured creditor, according to which the depositary bank has agreed to follow instructions from the secured creditor with respect to the payment of funds credited to the bank account without further consent of the grantor; or

(iii) If the secured creditor is the account holder.

There is no obligation on a depositary bank to enter into a control agreement. In addition, a secured creditor’s rights will be subject to the rights and obligations of the depositary bank under law and practice governing bank accounts. Moreover, a control agreement requires the consent of the grantor (as well as of the depositary bank) and the grantor retains the right to deal with the funds in the bank account until the secured creditor instructs the depositary bank otherwise (although in some control agreements, the funds would be blocked from the time of the conclusion of the control agreement). This covers situations where (a) an existing account is transferred to the secured creditor; (b) the secured creditor agrees with the grantor that funds should be deposited to an account to be opened later; and (c) the secured creditor is the only account holder (i.e. not merely a joint account holder);

(r) “Debtor” means a person that owes performance of the secured obligation and includes secondary obligors, such as guarantors of a secured

⁴ United Nations publication, Sales No. E.97.V.12.

obligation. The debtor may or may not be the person that grants the security right to a secured creditor (see the definition of the term “grantor”);

(s) “Debtor of the receivable” means a person liable for payment of a receivable. “Debtor of the receivable” includes a guarantor or other person secondarily liable on the receivable;

A guarantor in an accessory guarantee is not only a debtor of the receivable, the payment of which it has guaranteed, but also a debtor of the receivable that is constituted by the guarantee, as a guarantee is itself a receivable (i.e. there are two receivables);

(t) “Encumbered asset” means tangible or intangible property that is subject to a security right;

(u) “Equipment” means tangible property used by a person in the operation of its business;

(v) “Financial lease” means a lease, at the end of the term of which:

(i) The lessee automatically becomes the owner of tangible property other than negotiable instruments or negotiable documents subject to the lease;

(ii) The lessee may acquire the assets subject to the lease by paying no more than a nominal price; or

(iii) The tangible property subject to the lease has no more than a nominal residual value.

The term includes a hire-purchase agreement.

(w) “Grantor” means a person that creates a security right in one or more of its assets in favour of a secured creditor to secure either its own obligation or that of another person (see the definition of the term “debtor of the receivable”). Under the unitary approach, “grantor” of an acquisition security right includes a retention-of-title buyer, hire-purchase buyer, financial lessee or grantor in a purchase-money lending transaction. Because the general recommendations of the Guide apply not only to security rights in receivables but also to security transfers and outright transfers of receivables, unless otherwise provided, references to the “grantor” in the general recommendations also refer to the “assignor” (see definition of the term “debtor”);

(x) “Guarantor/issuer” means a bank or other person that issues an independent undertaking;

(y) “Independent undertaking” means a letter of credit (commercial or standby), a confirmation of a letter of credit, an independent guarantee (including demand, first demand, bank guarantee or counter-guarantee) or any other undertaking recognized as independent by law or practice rules, such as the United Nations Guarantee and Stand-by Convention, the Uniform Customs and Practice for Documentary Credits, the Rules on International Standby Practices and the Uniform Rules for Demand Guarantees;

(z) “Insolvency court” means a judicial or other authority competent to control or supervise insolvency proceedings;

(aa) “Insolvency estate” means assets and rights of the debtor that are controlled or supervised by the insolvency representative and subject to the insolvency proceedings;

(bb) “Insolvency proceedings” means collective judicial or administrative proceedings for the purposes of either reorganization or liquidation of the debtor’s business conducted according to the insolvency law;

(cc) “Insolvency representative” means a person or body responsible for administering the insolvency estate;

(dd) “Intangible property” means all forms of movable property other than tangible property and includes incorporeal rights, receivables and rights to the performance of obligations other than receivables;

(ee) “Intellectual property” means copyrights, trademarks, patents, service marks, trade secrets and designs and any other asset that is considered to be intellectual property under the domestic law of the enacting State or an international agreement to which it is a party;

(ff) “Inventory” means tangible property held for sale or lease in the ordinary course of the grantor’s business and also raw and semi-processed materials (work-in-process);

(gg) “Issuer” of a negotiable document means the person that is obligated to deliver the tangible property covered by the document under the law governing negotiable documents;

In the case of a so-called multimodal bill of lading (if it qualifies as a negotiable document under the applicable law), the “issuer” may be a person that subcontracts various portions of the transport of the goods to other persons but still takes responsibility for their transport and for any damage that might occur during carriage;

(hh) “Knowledge” means actual knowledge;

(ii) “Mass or product” means tangible property other than money that is so physically associated or united with other tangible property that it has lost its separate identity;

(jj) “Money” means currency currently authorized as legal tender by any State. It does not include funds credited to a bank account or negotiable instruments, such as cheques.

(kk) “Negotiable document” means a document, such as a warehouse receipt or a bill of lading, that embodies a right for delivery of tangible property and satisfies the requirements for negotiability under the law governing negotiable documents;

(ll) “Negotiable instrument” means an instrument, such as a cheque, bill of exchange or promissory note, that embodies a right to payment and satisfies the requirements for negotiability under the law governing negotiable instruments;

(mm) “Nominated person” means a bank or other person that is identified in an independent undertaking by name or type (e.g. “any bank in country X”) as being nominated to give value under an independent undertaking and that acts pursuant to that nomination and, in the case of a freely available independent undertaking, any bank or other person;

(nn) “Non-possessory security right” means a security right in (i) tangible property that is not in the actual possession of the secured creditor or another person holding the tangible property for the benefit of the secured creditor, or (ii) intangible property;

(oo) “Notice” means a communication in writing;

(pp) “Notification of the assignment” means a communication in writing that reasonably identifies the assigned receivable and the assignee;

(qq) “Original contract” in the context of an assignment means the contract between the assignor and the debtor of the receivable from which the receivable arises. With respect to non-contractual receivables, “original contract” means the non-contractual source of the receivable;

(rr) “Possession”, except as the term is used in recommendations 29 and 52-54 with respect to the issuer of a negotiable document, means the actual possession of tangible property by a person or an agent or employee of that person, or by an independent person that acknowledges that it holds for that person. It does not include constructive, fictive, deemed or symbolic possession;

(ss) “Possessory security right” means a security right in tangible property that is in the actual possession of the secured creditor or of another person (other than the debtor or other grantor) holding the asset for the benefit of the secured creditor;

(tt) “Priority” means the right of a person to derive the economic benefit of its security right in an encumbered asset in preference to a competing claimant;

(uu) “Proceeds” means whatever is received in respect of encumbered assets, including what is received as a result of sale or other disposition or collection, lease or licence of an encumbered asset, proceeds of proceeds, civil and natural fruits, dividends, distributions, insurance proceeds and claims arising from defects, damage to or loss of an encumbered asset;

(vv) “Proceeds under an independent undertaking” means the right to receive a payment due, a draft accepted or deferred payment incurred or another item of value, in each case to be paid or delivered by the guarantor/issuer, confirmer or nominated person giving value for a draw under an independent undertaking. The term also includes the right to request the purchase by a negotiating bank of a negotiable instrument or a document under a complying presentation. The term does not include:

(i) The right to draw (i.e. to request payment) under an independent undertaking; or

(ii) What is received upon honour of an independent undertaking or upon disposition of proceeds under an independent undertaking (i.e. the proceeds derived from collection or disposition of the proceeds under an independent undertaking).

This definition refers to “proceeds under an independent undertaking” to be consistent with terminology generally used in independent undertaking law and practice. The term as used in the Guide means the right of the grantor as beneficiary of an independent undertaking to receive whatever payment or other value is given under the independent undertaking contingent upon the beneficiary making a presentation complying with the terms and conditions of the independent

undertaking. The term does not include the proceeds themselves, i.e. what is actually received upon honour of a drawing by the guarantor/issuer, confirmer or nominated person (a beneficiary's receipt of value from a negotiating bank should not be characterized as honour or disposition) or upon disposition of a right to proceeds under an independent undertaking.

The term "proceeds under an independent undertaking" refers to a right to receive even though the term "proceeds" as used in independent undertaking law and practice may refer either to the right to receive or to whatever is received under the independent undertaking, and even though the term "proceeds" as used elsewhere in the Guide refers to whatever is received. A security right in proceeds under an independent undertaking (as an original encumbered asset) is different from a security right in "proceeds" (a key concept of the Guide) of assets covered in the Guide;

(ww) "Receivable" means a right to payment of a monetary obligation excluding rights to payment evidenced by a negotiable instrument, the obligation to pay under an independent undertaking and the obligation of a bank to pay funds credited to a bank account;

(xx) "Retention-of-title right", a term used only in the context of a non-unitary approach, means a seller's right in tangible property other than negotiable instruments or negotiable documents pursuant to an arrangement with the buyer by which title to the tangible property is not transferred from the seller to the buyer until the condition that the unpaid portion of the purchase price of the property be paid has been satisfied;

(yy) "Secured creditor" means a creditor that has a security right. With respect to a receivable, the term means the "assignee" of the receivable (see the definition of the term "assignment");

(zz) "Secured obligation" means the obligation secured by a security right;

(aaa) "Secured transaction" means a transaction that creates a proprietary (as opposed to personal) security right in movable property (as opposed to immovable property);

(bbb) "Security agreement" means an agreement between a grantor and a creditor, in whatever form or terminology, that creates a security right;

(ccc) "Security right" means a property right in movable property and attachments that is created by agreement and secures payment or other performance of one or more obligations, regardless of whether the parties have denominated it as a security right. In the context of a unitary approach, the term includes both acquisition security rights and non-acquisition security rights, but in the context of a non-unitary approach it does not include an acquisition financing right. With respect to receivables, security right also means the right of the assignee (see the definition of "assignment" and other definitions below relating to assignments of receivables);

(ddd) "Subsequent assignment" means an assignment by the initial or any other assignee. In the case of a subsequent assignment, the person that makes that assignment is the assignor and the person to which that assignment is made is the assignee; and

(eee) "Tangible property" means all forms of corporeal movable property. Among the categories of tangible property are inventory, equipment, attachments, negotiable instruments, negotiable documents and money.

I. Key objectives of an effective and efficient secured transactions regime

20. In the spirit of providing practical, effective solutions, the Guide explores and develops the following key objectives and themes of an effective and efficient secured transactions regime. These objectives are designed to provide a broad policy framework for the establishment and development of such a regime and could be reflected in a preamble of the law enacted by States. These objectives should be taken into account in the interpretation of the law (for such an approach, see, for example, art. 7, para. 1, of the United Nations Assignment Convention).

A. To promote secured credit

21. The primary overall objective of the Guide is to promote low-cost secured credit for persons in jurisdictions that adopt legislation based on the Guide's recommendations, thereby enabling such persons and the economy as a whole to obtain the economic benefits that flow from access to such credit (see para. 2 above).

B. To allow utilization of the full value inherent in a broad range of assets to support credit in the widest possible array of secured transactions

22. A key to a successful legal regime governing secured transactions is to enable a broad array of businesses to utilize the full value inherent in their assets to obtain credit in a broad array of credit transactions. In order to achieve this objective, the Guide emphasizes the importance of comprehensiveness, by (a) permitting a broad range of assets (including present and future assets) to serve as encumbered assets; (b) permitting the widest possible array of obligations (including future and conditional and monetary and non-monetary obligations) to be secured by security rights in encumbered assets; and (c) extending the benefits of the regime to the widest possible array of debtors, creditors and credit transactions.

C. To enable parties to obtain security rights in a simple and efficient manner

23. The cost of credit will be reduced if security rights can be obtained in an efficient manner. For this reason, the Guide suggests methods for streamlining the procedures for obtaining security rights and otherwise reducing transaction costs. These methods include eliminating unnecessary formalities; providing for a single method for creating security rights rather than a multiplicity of security devices for different kinds of encumbered assets; and permitting security rights in future assets and for future advances of credit without any additional documentation or action by the parties.

D. To provide for equal treatment of diverse sources of credit and of diverse forms of secured transaction

24. Because healthy competition among all potential credit providers is an effective way of reducing the cost of credit, the Guide recommends that the secured transactions regime apply equally to various credit providers, including banks and other financial institutions, and suppliers, as well as domestic and non-domestic creditors.

E. To validate non-possessory security rights

25. Because the granting of a security right should not make it difficult or impossible for the debtor or other grantor to continue to operate its business, the Guide recommends that the legal regime provide for non-possessory security rights in a broad range of assets coupled with a mechanism in the form of a public registry for providing notice to third parties as to the possible existence of such security rights.

F. To enhance predictability and transparency with respect to rights serving security purposes by providing for registration of a notice in a general security rights registry

26. Because an effective secured transactions regime should also encourage responsible behaviour by all parties to a secured transaction, the Guide seeks to promote predictability and transparency to enable the parties to assess all relevant legal issues and to establish appropriate consequences for non-compliance with applicable rules, while at the same time respecting and addressing confidentiality concerns. A primary means of accomplishing this goal is the establishment of a general security rights registry in which notices of security rights are registered.

G. To establish clear and predictable priority rules

27. A security right in assets will have little or no value to a creditor unless the creditor is able to ascertain, at the time a transaction is concluded, the priority of its right in such assets relative to the rights of other creditors (including an insolvency representative). Thus, the Guide proposes the establishment of a general security rights registry and, based on that registry, clear rules that allow creditors to determine the priority of their security rights at the outset of the transaction in a reliable, timely and cost-efficient manner.

H. To facilitate enforcement of creditors' rights in a predictable and efficient manner

28. A security right will also have little or no value to a secured creditor unless the creditor is able to enforce the security right in a predictable and time- and cost-efficient manner. Thus, the Guide proposes procedures that allow secured creditors to so enforce their security rights, subject to judicial or other official control, supervision or review when appropriate. The Guide also recommends that there be a

close coordination between a State's secured transactions laws and its insolvency laws with a view to respecting the pre-insolvency effectiveness and priority, as well as the economic value, of a security right subject to the appropriate rules of insolvency law.

I. To balance the interests of affected persons

29. Because secured transactions affect the interests of various persons, including the debtor, other grantors, competing creditors, such as secured, privileged and unsecured creditors, purchasers and other transferees of the encumbered assets, and the State, the Guide proposes rules that take into account their legitimate interests and seek to achieve, in a balanced way, all the objectives mentioned above.

J. To recognize party autonomy

30. Because an effective secured transactions regime should provide maximum flexibility to encompass a broad array of secured transactions, and also to accommodate new and evolving forms of secured transactions, the Guide stresses the need to keep mandatory rules to a minimum so that parties may tailor their secured transactions to their specific needs. At the same time, the Guide takes into account that other legislation may protect the legitimate interests of consumers or other persons and specifies that a secured transactions regime should not override such legislation.

K. To harmonize secured transactions laws, including private international law rules

31. Adoption of legislation based on the recommendations contained in the Guide will result in harmonization of secured transactions laws (through the adoption of similar substantive laws that will facilitate the cross-border recognition of security rights). This result in itself will promote the financing of international trade and the movement of goods and services across national borders. Furthermore, to the extent complete harmonization of national secured transactions laws might not be achieved, private international law rules would be particularly useful to facilitate cross-border transactions. In any event, private international law rules would be useful in order, for example, to help secured creditors to determine how to make their security rights effective against third parties (i.e. under the law of the location of the encumbered assets, the law of the location of the grantor or another law).

II. Scope of application and other general rules

A. Scope of application

32. The regime envisioned by the Guide is intended to be a single, comprehensive regime for secured transactions, affecting the widest possible array of assets, parties, secured obligations, security rights and other rights and financing practices.

1. Assets, parties, obligations and security and other rights

33. The primary focus of the Guide is on core commercial assets, such as commercial goods (inventory and equipment) and trade receivables. However, the Guide proposes that all types of asset are capable of being the object of a security right, including all present and future assets of a business, and covers all assets, both tangible and intangible (see A/CN.9/631, recommendation 2, subpara. (a)), with the exception of assets specifically excluded (see A/CN.9/631, recommendations 4-6).

34. The Guide covers all types of movable property and attachment, tangible or intangible, present or future, including inventory, equipment and other goods, contractual and non-contractual receivables, contractual non-monetary claims, negotiable instruments, negotiable documents, rights to payment of funds credited to a bank account, proceeds under an independent undertaking and intellectual property. With respect to receivables (which do not include negotiable instruments, negotiable documents and bank accounts; see the definition of “receivable” in para. 19 above), the general recommendations, as supplemented by the recommendations on receivables, apply both to (a) contractual and non-contractual receivables, except that recommendations 24 (Effectiveness of a bulk assignment of receivables) and an assignment of future, parts of and undivided interests in receivables) and 111 (Representations of the assignor) do not apply to non-contractual receivables; and (b) contractual non-monetary obligations. However, the rights of obligors of contractual non-monetary obligations are subject to law other than the law recommended in the Guide.

35. The Guide stresses the need to enable a grantor to create security rights not only in its existing assets but also in its “future” or “after-acquired” assets (i.e. assets acquired by the grantor or created after the conclusion of the security agreement), without requiring the grantor or secured creditor to sign any additional documents or to take any additional action at the time such assets are acquired or created. This approach is consistent, for example, with the United Nations Assignment Convention, which provides for the creation of security rights in future receivables without requiring any additional steps to be taken. In addition, the Guide recommends recognition of a security right in all existing and future assets of a grantor through a single security agreement, a concept that already exists in some legal systems as an “enterprise mortgage”, as a combination of fixed and floating charges, or as an “all-asset security right”.

36. Any person, physical or legal, may be a debtor, grantor or secured creditor under the Guide. Unless specifically indicated otherwise, the Guide also applies to consumers, inasmuch as there is no reason why consumers should be deprived of the benefits of the regime envisaged in the Guide. However, to the extent a rule of the regime envisaged in the Guide conflicts with consumer-protection law, consumer-protection law would prevail. States that do not have a body of law for the protection of consumers may wish to consider whether the enactment of a law based on the recommendations of the Guide would affect the rights of consumers and would thus require the introduction of consumer-protection legislation (see A/CN.9/631, recommendation 2, subpara. (b)).

37. The Guide also recommends that a broad range of obligations, monetary and non-monetary, may be secured. In addition, the Guide is intended to cover a broad range of transactions that serve security functions, including those related to

possessory and non-possessory security rights (see A/CN.9/631, recommendation 2, subparas. (c) and (d)).

38. The Guide deals with security rights created by agreement. However, it contains references to other rights, such as those provided by statute or judicial process, when the same property is subject to both security rights created by agreement and statutory or other rights, and the law must provide for the relative priority of such rights (see A/CN.9/631, recommendations 89-92).

39. To ensure a comprehensive coverage of all devices that serve security functions, the Guide also deals with rights that, while they are not denominated as security rights, nevertheless serve security purposes (e.g. transfers of title in tangible property for security purposes, outright transfers of receivables for security purposes and the various forms of retention of title (see A/CN.9/631, recommendation 2, subpara. (e)).

40. The only devices dealt with in the Guide that do not serve security functions, are those that involve purely outright transfers of receivables. This approach is justified by the need to avoid characterization issues and to ensure that the registry system and the priority rules of the Guide apply to all assignments of receivables (see paras. 41-45 below).

2. Outright transfers of receivables

41. The Guide does not apply to devices that do not serve security functions. The only exception to this rule relates to purely outright transfers of receivables, to which the Guide applies in order to ensure that all assignments of receivables are subject to the same rules (see A/CN.9/631, recommendations 3 and 162-164). However, as the definition of “receivable” (for the definition of “receivable”, see para. 19 above), excludes rights to payment under a negotiable instrument, the obligation to pay under an independent undertaking and the obligation of a bank to pay funds credited to a bank account, the Guide does not apply to purely outright transfer of such assets (the Guide applies, though, to transfers of such assets if they are made for security purposes).

42. Purely outright transfers of negotiable instruments, proceeds under an independent undertaking and rights to payment of funds credited to a bank account have been excluded because they raise different issues and would require special rules (the same considerations would apply to non-intermediated securities, if they were to be covered by the Guide). Moreover, in the case of receivables, a security transfer and an outright transfer would compete for priority based on the order of registration. However, the situation is different with negotiable instruments, proceeds under an independent undertaking and rights to payment of funds credited to a bank account. In the case of a negotiable instrument, a secured creditor can always obtain a superior right by taking possession of the instrument. Similarly, with respect to proceeds under an independent undertaking and rights to payment of funds credited to a bank account, a secured creditor can always obtain a superior right by control.

43. While principles of secured transactions law can easily be made applicable to the outright transfer of a promissory note, and perhaps a bill of exchange other than a cheque, in a manner similar to the Guide’s coverage of the outright transfer of receivables, those principles do not apply well to the outright transfer of cheques. The latter topic is sufficiently covered by the law of negotiable instruments and the law of bank collections.

44. An enacting State that wishes to expand the scope of its secured transactions law to apply to outright transfers of negotiable instruments that are either promissory notes or bills of exchange (and to expand its definition of “security right” to cover the right of the transferee in such a transaction) might wish to consider providing that a security right that is an outright transfer of such a negotiable instrument is automatically effective against third parties upon the transfer. Such a rule would avoid disrupting existing financial practices.

45. With respect to the priority of such a security right, the general principles of priority would apply. Most particularly, the general principle in recommendation 99 would govern. As in the case of an outright transfer of a receivable, the outright transferee of such a negotiable instrument should be able to enforce the instrument without further consent of the assignor subject to the rights of the obligors on the negotiable instrument as described in chapter X on post-default rights (see A/CN.9/631/Add.7).

3. Aircraft, railway rolling stock, space objects, ships, securities and intellectual property

46. The Guide does not apply to assets, such as aircraft, railway rolling stock, space objects and ships, as well as other categories of mobile equipment, in so far as such property is covered by national laws or international agreements to which the State enacting legislation based on the Guide is a party and the matters covered by this law are addressed in such national laws or international agreements (see A/CN.9/631, recommendation 4, subpara. (a)). The reference to aircraft, railway rolling stock, space objects and ships should be understood pursuant to the meaning of those terms in national law or international conventions dealing with them.

47. In view of the increasing importance and economic value of intellectual property assets to businesses seeking to obtain secured credit, the Guide applies in principle to security rights in intellectual property. However, as the recommendations have not been prepared with intellectual property issues in mind, in the case of any inconsistencies with national law or international agreements to which a State is a party, the Guide would not apply (see A/CN.9/631, recommendation 4, subpara. (b)). In order to avoid such inconsistencies, enacting States should examine their existing intellectual property laws and national laws or international agreements to which the State is a party and, if the recommendations of the Guide are inconsistent with any such laws or conventions [and the specific matters covered by the Guide’s recommendations are addressed in such national laws and international agreements], the State’s secured transactions law should confirm that those existing laws and conventions govern such issues. In considering whether any adjustments of the recommendations as they apply to security rights in intellectual property are appropriate, a State should analyse each case on an issue-by-issue basis and should have proper regard both to establishing an efficient secured transactions regime and to ensuring the protection and exercise of intellectual property rights in accordance with its national laws and international agreements.

48. Recommendation 4, subparagraphs (a) and (b), have been prepared against the background of whether there exist relevant special laws and international agreements that address the special matters covered by this law. For example, most countries have registries and detailed rules on security and other rights in ships, aircraft and the other types of mobile equipment described in recommendation 4, subparagraph (a). The registries are either recent or have been kept current as a

result of the need for financing of these types of property. The special laws and international agreements for mobile goods all cover, in varying degrees of precision, security rights. In contrast, various types of intellectual property are often not registered, or the registries are only evidence that a right has been issued or recognized by the Government and are not designed for the registration of security rights. In addition, some types of intellectual property have not traditionally been the subject of security rights and intellectual property law does not typically address the special matters covered by this law.

49. In addition, the Guide does not cover security rights in securities because the nature of securities and their importance for the functioning of financial markets raise a broad range of issues that merit special legislative treatment. The substantive law issues relating to security and other rights in securities held with an intermediary are dealt with in a draft convention being prepared by the International Institute for the Unification of Private Law (Unidroit). The law applicable to rights in [intermediated] securities is not addressed in the Guide since they are dealt with in the Convention on the Law Applicable to Certain Rights in respect of Securities held with an Intermediary. [However, the Guide does cover non-intermediated securities because of the importance of such securities to secured transactions involving small- and medium-sized businesses (see A/CN.9/631, recommendation 4, subpara. (c))].

[Note to the Commission: If the Commission decides that, pending future work on non-intermediated securities, such securities should be covered in the Guide, language would have to be included in recommendation 4, subparagraph (c), tracking the language of subparagraph (a) or (b), to safeguard the application of certain provisions of securities law at least until the necessary asset-specific recommendations on non-intermediated securities are prepared. In addition, non-intermediated securities would have to be excluded from the definition of "receivables" to ensure that the rules on receivables do not apply to such securities. Moreover, reference would need to be made to the definitions of "securities" and "intermediated securities" contained in the Unidroit preliminary draft convention on substantive rules regarding intermediated securities (see Unidroit document Study LXXVIII-Doc. 57, November 2006, article 1, subparas. (a) and (b)).]

50. The Guide is structured in such a way that the State enacting legislation based on the regime envisaged in the Guide can, at the same time, implement the texts prepared by Unidroit and the Hague Conference on Private International Law, as well as relevant texts prepared by UNCITRAL, such as the United Nations Assignment Convention and the *UNCITRAL Insolvency Guide* (see para. 12 above).

4. Immovable property

51. Immovable property (with the exception of attachments to immovable property, which can be subjected to security rights covered by the Guide) is excluded as it raises different issues and is subject to a special title registration system indexed by asset and not by grantor.

52. Although immovable property is excluded from the scope of the Guide as an originally encumbered asset, it may nevertheless be affected by the Guide's recommendations. For example, if a security right in a mortgage secures a receivable, negotiable instrument or other intangible asset, and the receivable, negotiable instrument or other intangible asset is assigned, the security right in the mortgage follows. This rule does not affect any third-party rights, priority and

enforcement requirements existing under immovable property law (see A/CN.9/631, recommendation 26).

5. Proceeds of excluded types of asset

53. If an asset is excluded from the scope of the Guide, law other than the secured transactions law should determine whether a security right in that asset nevertheless confers a security right in types of proceed to which the secured transactions law does apply (e.g. receivables representing proceeds of immovable property). Under the Guide, if such other law provides that a security right in such proceeds does exist, then the secured transactions law applies to that security right, except to the extent that the other law applies to [the third-party effectiveness, priority or enforcement of that security right][that security right] (see A/CN.9/631, recommendation 6).

6. Other exceptions

54. Because the objectives of the Guide are best achieved by a comprehensive secured transactions regime, the Guide recommends that any other exceptions to its scope of application not specifically set out in the Guide should be limited and, if there are any such exceptions, they should be set out in the law in a clear and specific way (see A/CN.9/631, recommendation 7).

B. Other general rules

1. Party autonomy

55. In modern secured transactions regimes, great emphasis is placed on party autonomy, namely the ability of the parties to derogate from, or vary, particular rules of the secured transactions regime except as limited by certain specified mandatory rules that reflect strong policy considerations. Modern secured transactions regimes also make it clear, however, that such agreements do not affect the rights of third parties that are not parties to the agreement. Such an approach is necessary in order to give the parties to secured transactions the greatest flexibility possible so as to enable them to tailor their transactions to meet their specific needs in a way that is consistent with the public policy of the enacting State. This is one of the most important ways in which a secured transactions regime can promote secured credit. The Guide adopts this approach (see A/CN.9/631, recommendation 8).

2. Electronic communications

56. Modern secured transactions regimes not only reflect modern concepts of secured transactions law, but also accommodate modern business practices by facilitating electronic communications. In this spirit, and consistent with article 9, paragraphs 2 and 3, of the United Nations Convention on the Use of Electronic Communications in International Contracts⁵ and articles 6 and 7 of the UNCITRAL Model Law on Electronic Commerce,⁶ the Guide contains a number of recommendations recognizing the ability of parties to conduct business using electronic communications (see A/CN.9/631, recommendations 9 and 10; see also

⁵ See United Nations publication, Sales No. E.07.V.2.

⁶ Ibid., Sales No. E.99.V.4.

article-by-article remarks on the United Nations Electronic Contracting Convention, paras. 143-165,⁵ and the *UNCITRAL Model Law on Electronic Commerce with Guide to Enactment 1996* with additional article 5 bis as adopted in 1998, paras. 47-61).⁶

C. Examples of financing practices covered in the Guide

57. Short examples of the types of secured credit transaction that the Guide is designed to encourage and to which reference is made throughout the Guide to illustrate specific points are set out below. These examples represent only a few of the numerous forms of secured credit transaction currently in use and an effective secured transactions regime must be sufficiently flexible to accommodate many existing methods of financing, as well as methods that may evolve in the future.

1. Inventory and equipment acquisition financing

58. Businesses often obtain financing for specific purchases of inventory or equipment. In many cases, the financing is provided by the seller of the tangible property (inventory and equipment) purchased. In other cases, the financing is provided by a lender. Sometimes the lender is an independent third party, but in other cases the lender may be an affiliate of the seller. The seller retains title or the lender is granted a security right in the tangible property purchased to secure the repayment of the credit or loan.

59. Here is an illustration of acquisition financing: ABC Manufacturing Company (ABC), a manufacturer of furniture, wishes to acquire certain inventory and equipment for use in manufacturing operations. ABC desires to purchase paint (constituting raw materials and, therefore, inventory) from Vendor A. ABC also wishes to purchase certain drill presses (constituting equipment) from Vendor B and certain conveyor equipment from Vendor C. Finally, ABC wishes to lease certain computer equipment from Lessor A.

60. Under the purchase agreement with Vendor A, ABC is required to pay the purchase price for the paint within 30 days of Vendor A's invoice to ABC, and ABC grants to Vendor A a security right in the paint to secure the purchase price. Under the purchase agreement with Vendor B, ABC is required to pay the purchase price for the drill presses within 10 days after they are delivered to ABC's plant. ABC obtains a loan from Lender A to finance the purchase of the drill presses from Vendor B, secured by a security right in the drill presses. ABC also maintains a bank account with Lender A and has granted Lender A a security right in the right to payment of funds credited to the bank account as additional security for the repayment of the loan.

61. Under the purchase agreement with Vendor C, ABC is required to pay the purchase price for the conveyor equipment when it is installed in ABC's plant and rendered operational. ABC obtains a loan from Lender B to finance the purchase and installation of the conveyor equipment from Vendor C, secured by a security right in the conveyor equipment.

62. Under the lease agreement with Lessor A, ABC leases the computer equipment from Lessor A for a period of two years. ABC is required to make monthly lease payments during the lease term. ABC has the option (but not the obligation) to purchase the equipment for a nominal purchase price at the end of the lease term.

Lessor A retains title to the equipment during the lease term but title will be transferred to ABC at the end of the lease term if ABC exercises the purchase option. This type of lease is often referred to as a “financial lease”. Under some forms of financial lease, title to the leased property is transferred to the lessee automatically at the end of the lease term. A financial lease is to be distinguished from what is usually called an “operating lease”. Under an operating lease, the leased property is expected to have a remaining useful life at the end of the lease term and the lessee does not have an option to purchase the leased property at the end of the lease term for a nominal price, nor is title to the leased property transferred to the lessee automatically at the end of the lease term.

63. In each of the above four cases, the acquisitions are made possible by means of acquisition financing provided by another person (seller, lender or financial lessor) who holds rights in the acquired property for the purpose of securing the acquisition financing granted. As the illustrations make clear, acquisition financing can occur with respect to both inventory and equipment.

2. Inventory and receivable revolving loan financing

64. Businesses generally have to expend capital before they are able to generate and collect revenues. For example, before a typical manufacturer can generate receivables and collect payments, the manufacturer must expend capital to purchase raw materials, to convert the raw materials into finished goods and to sell the finished goods. Depending on the type of business, this process may take up to several months. Access to working capital is critical to bridge the period between cash expenditures and revenue collections.

65. One highly effective method of providing such working capital is a revolving loan facility. Under this type of credit facility, loans secured by the borrower's existing and future inventory and receivables are made from time to time at the request of the borrower to fund the borrower's working capital needs. The borrower typically requests loans when it needs to purchase and manufacture inventory, and repays the loans when the inventory is sold and the sales price is collected. Thus, borrowings and repayments are frequent (though not necessarily regular) and the amount of the credit is constantly fluctuating. Because the revolving loan structure matches borrowings to the borrower's cash conversion cycle (that is, acquiring inventory, processing inventory, selling inventory, creating receivables, receiving payment and acquiring more inventory to begin the cycle again), this structure is, from an economic standpoint, highly efficient and beneficial to the borrower, and helps the borrower to avoid borrowing more than it actually needs.

66. Here is an illustration of this type of financing: It typically takes four months for ABC to manufacture, sell and collect the sales price for its products. Lender B agrees to provide a revolving loan facility to ABC to finance this process. Under the loan facility, ABC may obtain loans from time to time in an aggregate amount of up to 50 per cent of the value of its inventory that Lender B deems to be acceptable for borrowing (based upon the type and quality of the inventory, as well as other criteria) and of up to 80 per cent of the value of its receivables that Lender B deems to be acceptable for borrowing (based upon criteria such as the creditworthiness of the debtors of the receivables). ABC is expected to repay these loans from time to time as it receives payments from its customers. The loan facility is secured by all of ABC's existing and future inventory and receivables. In this type of financing, it is also common for the lender to obtain a security right in the right to payment of

funds credited to the bank account into which customer payments (i.e. the proceeds of inventory and receivables) are deposited.

3. Factoring

67. Factoring is a highly effective form of receivables financing that can trace its roots back thousands of years. In general, factoring involves the outright purchase of receivables from the grantor, as seller (assignor) to the factor (assignee). Such an outright transfer of receivables falls within the definition of a security right for purposes of the Guide (for the definition of “security right”, see para. 19 above).

68. There are a number of different types of factoring arrangement. The factor may pay a portion of the purchase price for the receivables at the time of the purchase (“discount factoring”), only when the receivables are collected (“collection factoring”), or on the average maturity date of all of the factored receivables (“maturity factoring”). The assignment of the receivables can be with or without recourse to the assignor (“recourse” and “non-recourse” factoring) in the event of non-payment of the receivables by the debtors of the receivables (i.e. the customers of the assignor). Finally, the debtors of the receivables may be notified that their receivables have been the subject of factoring (“notification factoring”), or they may not be so notified (“non-notification factoring”). When notice is given to the customers, it is often accomplished by requiring the assignor to place a legend on the invoices that the assignor sends to its customers. The factor may also perform various services for the assignor in respect of the receivables, ranging from approving and evaluating the creditworthiness of the debtors of the receivables, performing bookkeeping duties and engaging in collection efforts with respect to receivables that are not paid when due. These services can provide a useful benefit to companies that do not have their own credit and collection departments.

69. Here is an illustration of a typical factoring arrangement: ABC enters into a discount factoring arrangement with Factor, pursuant to which Factor agrees to purchase receivables that Factor deems to be creditworthy. Factor advances to ABC an amount equal to 90 per cent of the face value of such receivables, holding the remaining 10 per cent as a reserve to cover potential customer claims and allowances that would reduce the value of the receivables. The factoring arrangement is with notification to ABC’s customers.

4. Securitization

70. Another highly effective form of financing involving the use of receivables is securitization. Securitization is a sophisticated form of financing under which a business enterprise can obtain less expensive financing based on the value of its receivables by transferring them to a wholly owned “special purpose vehicle” (“SPV”) that will issue securities in the capital markets secured by the stream of income generated by such receivables. For example, this technique is commonly used in situations where a company’s receivables consist of credit card receivables, rents or home mortgages, although the securitization of many other types of receivables is also possible. Securitization transactions are complex financing transactions that are also dependent upon a jurisdiction’s securities laws as well as its secured transactions laws.

71. Securitization is intended to lower the cost of financing because the SPV is structured in a way to make the risk of its insolvency “remote” (e.g. theoretically not possible) by restricting the amount of debt that the SPV can incur.

That significantly reduces one risk that the lender has to take into account when deciding what interest rate to charge for the loan. In addition, because the source of credit is the capital markets rather than the banking system, securitization can generate greater amounts of credit than bank loans and at lower costs than the normal bank loan costs.

72. Here is an illustration of a securitization transaction: an SPV is created by a subsidiary of an automobile manufacturer to purchase automobile leases from automobile dealers throughout a geographically defined market. The automobile leases are purchased from the dealers for a discount from the projected value of the payment streams expected to be generated by such leases. The SPV then issues debt securities, under applicable securities laws, to investors in the capital market secured by such income stream. As payments are made under the leases, the SPV will use such proceeds to make payments on the debt securities.

5. Term loan financing

73. Businesses often need financing for large, non-ordinary-course-of business expenditures, such as the acquisition of significant equipment or the acquisition of a business. In these situations, businesses generally seek loans that are repayable over a fixed period of time (with principal being repaid in monthly, quarterly or other periodic instalments pursuant to an agreed-upon schedule or in a single payment at the end of the loan term).

74. As is the case with many other types of financing, a business that does not have strong, well-established credit ratings will have difficulty obtaining term loan financing, unless the business is able to grant security rights in its assets to secure the financing. The amount of the financing will be based in part on the creditor's estimate of the net realizable value of the assets to be encumbered. In many States, immovable property is the only type of asset that typically is accepted by lenders to secure term loan financing and, as a result, in such States term loan financing is often not available for other important asset types, such as equipment or the enterprise value of an entire business. This is most likely the case in States that do not have a modern secured transactions regime. However, many businesses, in particular newly established businesses, do not own any immovable property and, therefore, may not have access to term loan financing. In other States, term loans secured by movable property, such as equipment, intellectual property and the enterprise value of the business, are common.

75. Here is an illustration of this type of financing: ABC desires to expand its operations and purchase a business. ABC obtains a loan (predicated on the value of, and secured by, substantially all of the assets of the business being acquired) from Lender C to finance such acquisition. The loan is repayable in equal monthly instalments over a period of 10 years and is secured by existing and future assets of ABC and the entity being acquired.

6. Transfer of title for security purposes

76. In States that honour a form of transfer of ownership even when it does not entail a transfer of possession and is done for financing purposes, a transaction denominated as a transfer of title by way of security (or sometimes as a "fiduciary" transfer of title) is recognized. These transactions are essentially non-possessory security rights, and they are primarily used in States where the secured transactions law has not yet generally recognized non-possessory security rights.

7. Sale and leaseback transactions

77. A sale and leaseback transaction provides a method by which a company can obtain credit based upon its existing tangible property (usually equipment) while still retaining possession and the right to use the tangible property in the operation of its business. In a sale and leaseback transaction, the company will sell its assets to another person for a specific sum (which the company may then use as working capital, to make capital expenditures or for other purposes). Simultaneously with the sale, the company will lease the equipment back from that other person for a lease term and at a rental rate specified in the lease agreement. Often, the lease is a “financial lease” as opposed to an “operating lease”.

D. Recommendations

[Note to the Commission: The Commission may wish to note that, as document A/CN.9/631 includes a consolidated set of the recommendations of the draft legislative guide on secured transactions, the recommendations are not reproduced here. Once the recommendations are finalized, they will be reproduced at the end of each chapter.]

III. Basic approaches to security

A. General remarks

1. Introduction

78. Over time, a broad variety of legal institutions have been developed by different States to encourage lenders and sellers to extend credit to borrowers and buyers. Often, States have enacted special statutory rights for lenders and sellers so as to encourage them to extend credit. Commonly, States have also established regimes to enable creditors and debtors to contract between themselves for special rights. In both cases, the objective was to give the creditor a preference over other creditors in the distribution of the proceeds generated by the seizure and sale of a debtor’s property in the event the debtor failed to perform the promised obligation. These various types of rights can, broadly speaking, be understood as security rights (for the definition of “security right”, see para. 19 above).

79. The main purpose of this chapter is to provide a survey of the major approaches to affording security to creditors. The chapter discusses the advantages and disadvantages of each approach to the immediate parties involved (i.e. creditor and grantor) and to third parties and outlines the major policy options for legislators in selecting among the various possible approaches. The chapter also stresses the reasons why modernization of the law in this area is necessary in order to promote secured credit and the contexts in which the need for modernization is most pressing.

80. In general terms, the devices that are currently being used for purposes of security fall into three broad categories: first, specific devices designed for, and openly denominated as, security (see sect. A.2 below); second, title (ownership) devices combined with various types of contractual arrangement (see sect. A.3 below); and third, integrated, comprehensive security devices that comprise a functionally defined generic concept of a security right (see sect. A.4 below).

81. As noted, in many States today, not all legal devices used by lenders, sellers and other parties to extend credit are based on an agreement. Some arise by operation of law. The more important of these will be noted in each section below, but since statutory security rights are, for the most part, outside the scope of this Guide (with the exception of chapter VII on priority; see A/CN.9/631/Add.4), the following discussion will focus on security devices based on an agreement.

2. Instruments traditionally designed for security

(a) Security rights in tangible property

82. Most States distinguish between security rights in tangible property and security rights in intangible property (for the definitions of “intangible property” and “tangible property”, see para. 19 above). Because tangible property may be the subject of physical possession, and because many States attach significant legal consequences to the possession of tangible property, it is often the case that States permit types of security right to be taken in tangible property that are not available for intangible property.

83. With respect to security rights in tangible property, most States draw a distinction between possessory and non-possessory security rights (for the definitions of “non-possessory security right” and “possessory security right”, see para. 19 above). In the case of possessory security rights, possession of the encumbered asset is transferred to the secured creditor or a third party, or to a person acting on behalf of the secured creditor. In the case of non-possessory security rights, the grantor, which is usually the debtor but can also be a third party, retains possession of the encumbered asset (for the definitions of “debtor”, “encumbered asset”, “grantor” and “secured creditor”, see para. 19 above).

(i) Pledges

84. By far the most common type of security right in tangible property is the pledge. Traditionally, a pledge requires for its validity that the grantor relinquish possession of the encumbered asset. Today, many States have extended the term “pledge” to situations where the grantor retains physical possession of the encumbered asset. In this Guide, these modern types of pledge are considered to be non-possessory security rights and not pledges.

85. An ordinary pledge arises where the grantor effectively gives up possession of the encumbered asset to the secured creditor or to a third party agreed upon by the parties (e.g. a warehouse). The actual holder may also be an agent or trustee that holds the security in the name or for the account of the creditor, or a syndicate of creditors. The required dispossession of the grantor must not only occur when the security right is created, but must also be maintained during the duration of the pledge. The return of the encumbered asset to the grantor usually extinguishes the pledge.

86. In many States, dispossession need not always require physical removal of the encumbered assets from the grantor’s premises, provided that the grantor’s access to the assets is precluded in another way. This can be achieved, for example, by giving to the secured creditor the keys to the warehouse in which the encumbered assets (merchandise or raw materials) are stored, provided that doing so prevents any unauthorized access by the grantor. The same result can be achieved by delivering the encumbered assets to a third party. For example, an independent “warehousing”

company may be engaged to exercise control over the encumbered assets, as agent for the secured creditor, on the grantor's premises. Under such an arrangement (sometimes known as "field warehousing"), the encumbered assets are stored in an area of the grantor's premises that is delineated or in some manner under the exclusive control of the warehousing company. For these types of arrangement to be valid, several conditions must usually be fulfilled. It must be obvious to a third party that the grantor does not have free access to the encumbered assets. In addition, there cannot be any unauthorized access by the grantor to the area in which the pledged assets are stored. Furthermore, the employees of the warehousing company cannot work for the grantor. If they are drawn from the grantor's workforce because of their expertise or for other reasons, their terms of employment must be adjusted so that they no longer work for the grantor.

87. While most pledges are taken over items of tangible property, tangible property also embraces a wider set of property. Assets of a special nature, such as documents and instruments (whether negotiable or non-negotiable), embody rights in tangible property (e.g. bills of lading or warehouse receipts) or in intangible payment rights (e.g. negotiable instruments). In such cases, the grantor is dispossessed through the transfer of physical possession of the document or instrument to the secured creditor.

88. As a security right, the pledge presents five important advantages for the secured creditor, arising from the fact that the grantor is dispossessed and the secured creditor has actual possession of the encumbered assets. First, the grantor is unable to dispose of the pledged assets without the secured creditor's consent. Second, the secured creditor does not run the risk that the actual value of the pledged assets will be reduced through the grantor's failure to provide any necessary upkeep or maintenance. Third, in cases where the creditor can use the pledged assets, the parties will often agree that the creditor may do so as long as it takes proper care of them. Fourth, if the pledged asset is an instrument that bears interest payable to the holder, the pledge facilitates the creditor's collection of the repayment obligation as instalments come due. Fifth, if enforcement becomes necessary, the secured creditor is saved the trouble, time, expense and risk of having to seek to obtain delivery of the encumbered assets from the grantor.

89. The pledge also has advantages for third parties, especially when these third parties are the grantor's other creditors. The required dispossession of the grantor avoids any risk of creating a false impression of the grantor's wealth (e.g. that the grantor actually owns the pledged assets or owns them free of any encumbrances) and also minimizes the risk of fraud.

90. On the other hand, the pledge also has major disadvantages. The greatest disadvantage for the grantor is the required dispossession itself, which precludes the grantor from using the encumbered assets in its business. This disadvantage is acute in situations where possession of the encumbered assets is necessary for commercial grantors to generate the income from which to repay the loan, as is the case, for example, with raw materials, semi-finished goods (work-in-process), equipment and inventory. This disadvantage alone makes the pledge economically impractical in many business contexts. Another important disadvantage is that assets that do not exist or in which the grantor does not have rights at the time of the pledge, cannot be pledged. This means that a number of practices, such as inventory financing on the basis of a revolving credit facility, cannot be accommodated.

91. For the secured creditor, the pledge has the disadvantage that the secured creditor has to store, preserve and maintain the encumbered assets, unless a third party assumes this task. Where secured creditors themselves are neither able nor willing to perform these tasks, entrusting third parties to do so will involve additional costs that will be directly or indirectly borne by the grantor. Another disadvantage is that a secured creditor in possession of encumbered assets (e.g. a pledgee or holder of a warehouse warrant or a bill of lading) may, depending upon the type of asset involved, be exposed to potential liability in various circumstances for loss or damage caused by the encumbered assets, which may exceed the amount of the credit extended, as is the case where the encumbered asset causes contamination of the environment (see chapter IV on creation of a security right; para. 200 below).

92. However, where the parties are able to avoid these disadvantages, the pledge can be utilized successfully and efficiently as a security device. There are two major fields of application. The first field of application is where the encumbered assets are already held by, or can easily be brought into the possession of, a third party, especially a person, such as a warehouse, engaged in the business of maintaining possession of assets owned by other persons. The second field of application is negotiable instruments and negotiable documents, which can be easily held by the secured creditor itself.

(ii) *Right of retention of possession*

93. Although statutory rights of retention of an asset are generally outside the scope of this Guide (with the exception of chapter VII on priority; see A/CN.9/631/Add.4), they are briefly discussed here, since they secure payment of an obligation. Many States have extensive regimes governing statutory retention rights. Typically, these regimes cover carriers, warehouses, repairers and improvers. In some States, lawyers, accountants, architects and other professionals are also given a right of retention over documents belonging to their clients. All of these types of right of retention arise from the general legal principle of contract law that a party is not required to perform its obligation until the other party is ready, willing and able to perform the correlative obligation. Most of these types of legal retention right do not give the retainer any special enforcement rights, and some do not even permit the retainer that seizes and sells the retained property to claim a priority in the proceeds of the sale in the context of enforcement.

94. In addition to these limited statutory rights of retention, many States permit contracting parties to extend the scope of the general legal principle and to agree that, should one of them be in breach of a contractual obligation, the other may withhold its own performance even when the performance relates to a different contract between the parties. In particular, these States permit a party to withhold an asset that, under the terms of some other contract, the withholding party is obliged to deliver to the party in breach. For example, a bank need not return a negotiable document (such as a bill of lading) or negotiable instrument (such as a bill of exchange or a promissory note) that it holds for its customer or allow withdrawals from the customer's bank account, if the customer is in default on repayment of a credit and had agreed to grant the bank a right of retention. Where such a right of retention is reinforced by a valid power to sell the retained item, some legal systems regard such a reinforced right of retention as a type of pledge, although the method of its creation deviates from that of the pledge proper. Alternatively, a reinforced right of retention may be regarded as having some of the effects of a pledge.

The most important consequence of such assimilation to a pledge is that the creditor in possession has a priority in the assets retained, unless they are subject to an earlier created and effective security right not effected by possession.

(iii) *Non-possessory security rights*

95. As noted above (see para. 90), a pledge in tangible property required for production or sale (such as equipment, raw materials, semi-finished goods and inventory) is economically impractical. In the case of a commercial grantor, the grantor must have possession of these goods in order to operate its business. Without access to the goods and the right to dispose of them, the grantor would not be able to earn the necessary income to repay the loan.

96. To address this problem, States, especially in the second half of the twentieth century, began to recognize security rights in movable property outside the narrow confines of pledges. While in some cases this recognition was reflected in the enactment of new laws, in many cases it resulted from practice and court decisions. Although some States introduced a new security right encompassing various arrangements serving security purposes, most States continued the tradition of the nineteenth century (which disregarded an earlier, more liberal attitude) and insisted on the possessory pledge as the only legitimate method of creating security in movable property. During the twentieth century, legislators and courts in many of those States have come to acknowledge the urgent economic need to provide for some form of non-possessory security right.

97. Individual States attempted to find appropriate solutions according to particular local needs and in conformity with the general framework of their legal system. The result is a diverse range of solutions. An external indication of the existing diversity is the variety of names for the relevant devices, sometimes differing even within a single State. The more common names and techniques are fictive dispossession of the grantor, non-possessory pledge, registered pledge, *nantissement*, warrant, *hypothèque mobilière*, contractual privilege, bill of sale, chattel mortgage, floating charge and trust receipt. That is, while some States sought to create a denominated non-possessory security device over movable property, other States simply modified the rules governing existing devices like the pledge, in order to permit non-possessory security rights.

98. An even more relevant feature of these legislative reforms is that most were conceived as limited responses to particular problems and were therefore given a restricted scope of application. For example, in some States, there is one type of non-possessory security device applicable to business and commercial equipment, another applicable to the financing of raw materials and a third only applicable to retail inventory. Only a few States have enacted a general statute creating a non-possessory security right applicable to all forms of movable property. Furthermore, some States have different sets of legislation on non-possessory security rights depending on the type of business enterprise in question: one dealing with security for financing of industrial and artisan enterprises, another with security for financing of farming, fishing and fishing enterprises, another with security for financing of mining and extractive industries, and a fourth dealing with transactions between individuals. Finally, in many States, there is a variety of statutes on non-possessory security rights, each covering only a small economic sector, such as the acquisition of cars or farm machinery, or the production of films.

99. Some States have addressed the matter through a device known as a “fixed charge” or a “floating charge”. Under this type of device, a security right is denominated as a “fixed charge” or a “floating charge” depending upon the degree of control that the secured creditor exerts with respect to the encumbered asset. In general, the creditor has a fixed charge on an encumbered asset if the grantor is not permitted to sell or otherwise dispose of the asset without the creditor’s consent (generally the case with equipment that the grantor uses in its business) and has a floating charge on an encumbered asset if the grantor is permitted to sell or otherwise dispose of the asset without the consent of the secured creditor (generally the case with inventory that the grantor is free to sell in the ordinary course of its business). The relevance of the difference between a fixed charge and a floating charge on an asset relates to the priority of the charge: a fixed charge generally represents a paramount charge on the asset, while a floating charge may be subject to certain preferential claims in favour of tax authorities and other third parties, or a carve-out in favour of unsecured creditors (see also para. 196 below).

100. In some States, there is some reluctance to allow non-possessory security rights in inventory. This is sometimes based upon an alleged inconsistency between the creditor’s security right and the grantor’s right to sell, which is indispensable for converting the inventory to cash with which the grantor will repay a secured loan. Another reason is that the disposition of inventory often gives rise to difficult conflicts between multiple transferees of the encumbered assets or multiple secured creditors. A third reason may arise from a policy decision to reserve inventory for the satisfaction of the claims of the grantor’s unsecured creditors.

101. Varied as the legislation providing for non-possessory security rights may be, it shares one common feature, namely that some form of publicity of the security right is usually required or available. The purpose of publicity, such as that provided by the possession of a pledged asset, is to dispel the false impression of wealth that might arise if the security right in assets held by the grantor is not apparent to third parties. It is often argued, however, that in a modern credit economy, parties should assume that assets may be encumbered by a lender’s security right or may be subject to a seller’s retention of title. For this reason, the argument goes, a general requirement that non-possessory security rights be published is not necessary to protect third parties. Such general assumptions, however, are bound to increase the cost of credit. Even in cases where the person in possession is the owner and the assets are not encumbered, a creditor will not run the risk of there being a hidden encumbrance and will adjust the cost of credit accordingly. Alternatively, the creditor will try to avoid the risk (only partially) through an extensive, time-consuming and costly search. Finally, in systems based on the general assumption that assets will be encumbered and which, consequently, do not have integrated and fully transparent registries, there is no objective basis for a creditor to know the actual extent to which assets are encumbered and the relative priority of competing security rights. The result is that grantors may not be able to use the full value of their assets to obtain credit.

102. There appears to be a generally recognized need to bridge the gap between the general economic demand for non-possessory security rights and the often-limited access to such security under current law in many States. A major purpose of legal reform in the area of secured transactions is to improve in the field of non-possessory security rights and in the related field of security in intangible property (see sect. A.2 (b) below).

103. While modern regimes demonstrate that difficulties can be overcome, experience shows that legislation on non-possessory security rights requires more effort than simply “modernizing” the traditional possessory pledge. This is due mainly to the following four key characteristics of non-possessory security rights. First, as the grantor retains possession, it has the power to dispose of the encumbered asset or create a competing right in it, even against the secured creditor’s will. This situation necessitates the introduction of rules concerning the effects and priority of such dispositions (see chapter VII on priority; A/CN.9/631/Add.4). Second, the secured creditor must ensure that the grantor in possession takes proper care of, duly insures and protects the encumbered assets to preserve their commercial value, matters which must all be addressed in the security agreement between the secured creditor and the grantor (see chapter VIII on rights and obligations of the parties; A/CN.9/631/Add.5). Third, if enforcement of the security right becomes necessary, the secured creditor will usually prefer to obtain the encumbered assets. However, if the grantor is not willing to part with possession of those assets, judicial or extrajudicial proceedings may have to be instituted. Proper remedies, and possibly accelerated enforcement proceedings, may have to be provided for (see chapter X on post-default rights; A/CN.9/631/Add.7). Fourth, the appearance of false wealth in the grantor created by “secret” security rights of third persons in assets held by the grantor, may have to be counteracted by various forms of publicity (see chapter VI on the registry system; A/CN.9/631/Add.3).

104. In the light of the generally recognized economic need for allowing non-possessory security rights and the basic differences discussed above between possessory and non-possessory security rights, new legislation will be necessary in many States taking account of the relative advantages and disadvantages.

105. In view of the legislative models discussed above, legislators may be faced with three options. One option may be to adopt integrated legislation for both possessory and non-possessory security rights (see sect. A.4 below). This is the approach, for example, of the OAS Model Inter-American Law on Secured Transactions, adopted in February 2002. A second option may be to adopt integrated legislation for non-possessory security rights, leaving the regime on possessory security rights to other domestic law. A third approach may be to maintain a fragmented system of different security rights for different types of grantor, different types of asset and different types of security (possessory and non-possessory), but to ensure that all issues relating to third-party effectiveness, priority and enforcement are dealt with under the same set of rules.

106. The prevailing trend in modern legislation, both at the national and the international level, is towards an integrated approach, at least as far as non-possessory security rights are concerned. A selective regulation of specific types of non-possessory security right is likely to result in gaps, overlaps, inconsistencies and lack of transparency, as well as in discontent in those sectors of industry that might be excluded. In addition, such selective regulation makes it more difficult to address conflicts of priority between possessory and non-possessory security rights in States that choose to retain separate regimes for these two types of security right.

(iv) *Non-possessory statutory rights*

107. Many States do not have an integrated regime governing non-possessory security rights or even an array of specialized regimes for non-possessory security rights. In these States, credit is encouraged through statutes granting particular

non-contractual rights to certain categories of creditors. Among the more common beneficiaries of these statutory rights are sellers, suppliers of materials, artisans, tradesmen and repairers. The regimes in question typically do not give the designated creditor a right to exercise special enforcement remedies. The beneficiary of the right must obtain judgement and then seize the property of the debtor in the ordinary way. The sole advantage that the creditor obtains is a priority for payment (or privilege) that may be claimed in the proceeds of the sale in the context of enforcement. Moreover, because the beneficiary of the right normally does not have to publicize its non-possessory statutory right, it is rare that the right can be claimed in property that no longer belongs to the debtor.

108. The existence of these types of statutory non-possessory right does go some way in encouraging the designated beneficiaries to advance credit to their debtors. But they have several disadvantages. They are not available to all types of credit provider. They are secret, in the sense that there is no easy way for other third parties to know of their existence. They do not give creditors access to expeditious enforcement remedies that are likely to generate a higher price upon the sale of the asset. Finally, they provide only a fragile protection to creditors since they cannot be claimed once the debtor no longer owns the property. For all these reasons, the modern trend is for States to cut back on the number of these non-possessory rights and privileges and to expand both the categories of creditors that may contract for a non-possessory security right and the types of asset over which a non-possessory security right may be taken by agreement.

(b) Security rights in intangible property

109. Intangible property comprises a broad variety of rights, such as receivables and intellectual property (for the definitions of “intangible property”, “intellectual property” and “receivable”, see para. 19 above). In view of the dramatic increase in the economic importance of intangible property in recent years, there is a growing demand to use these rights as assets for security. Intangible property (especially in the form of intellectual property) often represents a significant component of the value of other assets, as in the case of inventory and equipment (e.g. goods bearing a valuable trademark and software essential to the operation of equipment). Furthermore, proceeds of inventory or equipment may take the form of intangible property. [Except for certain types of non-intermediated securities,] the Guide does not deal with securities, since they raise a range of issues requiring special treatment and these issues are addressed in a text being prepared by Unidroit and in the Convention on the Law Applicable to Certain Matters Relating to Securities held with an Intermediary. The Guide does, however, discuss security rights in receivables, as well as security rights in other types of intangible property.

110. By definition, intangible property is incapable of being physically possessed. Nevertheless, codes in many States (including “civil law” States) have dealt with the creation of security rights in intangible property, at least in the case of receivables, by modifying the regime governing the creation of possessory pledges. Some codes have attempted to create the semblance of dispossession by requiring the grantor to transfer any writing or document relating to the pledged receivable (such as the contract from which the receivable is derived) to the creditor. However, such a transfer, in itself, is not sufficient to create the pledge. Rather, the grantor’s “dispossession” is, in many States, symbolized by requiring that a notice of the pledge be given to the debtor of the receivable.

111. In some States, techniques have been developed that achieve ends comparable to those attained by the possession of tangible property. The most radical method is the full transfer of the encumbered right (or the encumbered share of it) to the secured creditor. However, this goes beyond creation of a security right and amounts to a transfer of title, whether conditionally or absolutely (see sect. A.3 (a) below). Under a more restrained approach, title to the encumbered assets is not affected, but dispositions by the grantor that are not authorized by the secured creditor are blocked. In the case of a bank account, if the grantor (the creditor of the encumbered account), as holder of the account, agrees that its account can be blocked in favour of the secured creditor, the latter has the equivalent of possession of tangible property. That is especially the case if the depositary bank itself is the secured creditor.

112. Such techniques of obtaining “possession” of intangible property are sometimes referred to as “control” in modern secured transactions regimes. In general, a secured creditor is deemed to have control of an asset if it has the contractual right to direct the disposition of the asset. For example, in some States a secured creditor may be deemed to have control of the right to payment of funds in a bank account if the depositary bank has contractually bound itself (in a document often referred to as a “control agreement”) to dispose of the funds in the account exclusively at the direction of the secured creditor (for the definition of “control” with respect to a right to payment of funds credited to a bank account, see para. 19 above). The degree of control may vary. In some cases, the control is absolute and any disposition by the grantor is prevented. In other cases, the grantor is allowed to make certain dispositions or dispositions up to a fixed maximum aggregate amount, or until the occurrence of a specified event (sometimes referred to as a “triggering event”).

113. In the context of efforts to create comprehensive regimes for non-possessory security rights in tangible property (see sect. A.2 (a) above), it is common for security rights in one of the most important types of intangible property, receivables, to be integrated into the legal regime applicable to possessory security rights to tangible property. This approach serves consistency, since the sale of inventory results, as a rule, in receivables being generated and it is often desirable to extend the security in inventory to the resulting proceeds. The general registry system used for security in tangible property can perform its salutary functions for security in intangible property, such as receivables, as well (for details concerning the registry system, see A/CN.9/631/Add.3). This may have the additional benefit of dispensing with the notification of the debtor of the receivable, which in certain secured transactions involving a pool of present and future assets that are not specifically identified may not be practical or feasible. Even if such notification is practical or feasible, it may not be desirable for reasons of confidentiality.

114. In the light of experience with different models for governing security rights in intangible property, new legislation will be necessary in many States. Taking account of the advantages and disadvantages of these approaches, States will face a basic choice. They may either attempt to regulate security rights in intangible property in a regime separate from that governing security rights in tangible property (in which case the technique for generating security will closely resemble a transfer of title) or they may attempt to create an integrated regime that seeks to create a common set of principles governing creation, third-party effectiveness, priority and enforcement of security rights in tangible and intangible property.

115. The predominant tendency in modern legislation is to develop regimes that treat security rights in intangible property under an integrated regime that also governs security rights in tangible property. Such an approach permits grantors and creditors to determine at the outset of their transaction the assets to be encumbered, to establish the relationship between rights in receivables that arise as proceeds and rights that arise when the same receivables are the initially encumbered asset, and to avoid inconsistency and lack of transparency.

3. Use of title for security purposes

116. In many States, alongside various devices and techniques that are intended to function as security rights (see sect. A.2 above), there exists a variety of other legal instruments that can be deployed to generate the equivalent of a security right. Most of these instruments developed through commercial practices, the validity of which was confirmed by courts, but some were either established by or refined through legislation. In so far as creating the equivalent of non-possessory security rights in tangible and intangible property is concerned, the most commonly found alternative instruments and techniques involve the use of title (or ownership) to the asset that is being deployed for security purposes. Title may be used in this way either by the grantor transferring title to the creditor (see sect. A.3 (a) below) or by a creditor (typically a seller or lessor) retaining title to the property that is sold or leased (see sect. A.3 (b) below). Both transfer of title and retention of title enable the creditor to benefit from rights that are equivalent to non-possessory security rights, which, as previously discussed, are essential from an economic standpoint.

(a) Transfer of title

117. Because the various regimes failed to address non-possessory security rights, debtors and creditors looked elsewhere in the law to find principles that could be used to fill gaps or address obstacles to the creation of non-possessory security rights. The transfer of title of the assets to the secured creditor (either conditionally until the loan is repaid or subject to a retransfer to the borrower under a second sale by which the creditor retains title until the loan is repaid) is the most usual technique deployed for this purpose.

118. Today, there are two features that continue to make the security transfer of title attractive for creditors in many States. First, the formal and substantive requirements for transferring title in tangible or intangible property to another person are often less onerous, and therefore less costly, than the requirements for creating a security right. Second, in the case of enforcement, and in the case of the grantor's insolvency, a creditor often has a better position as an owner than as a holder of a security right. This is especially the case where the owner's assets, although in the grantor's possession, are determined to not be part of the insolvency estate, by contrast with the situation where the grantor's assets, if merely encumbered by a security right for the creditor, are deemed to be part of the insolvency estate (see chapter XI on insolvency; A/CN.9/631/Add.8). These two features are not, however, invariably present in national law. For example, in many States the formal difference between title for security purposes and security rights with respect to the requirements for creation or enforcement has been eliminated, to the extent that title devices and security rights are treated the same with respect to their creation. In other States, security transfers are generally subject to the rules applicable to transfers of title while, in the case of enforcement and insolvency, they are treated as security devices.

119. The security transfer of title has been established by law in some States (usually under regimes dealing with sales with a right to reclaim or repurchase) and by practice and courts in other States. Today, there is a variety of approaches that States take to the transfer of title for security purposes. As noted, in some States, its creation is subject to the less demanding rules governing transfers of title and it has the effect of a full transfer of title. In other States, its creation is subject to the more cumbersome rules governing security rights and it has only the effect of a secured transaction. In yet other States, especially from the civil law world, many if not all such transfers of title are regarded as a circumvention of the ordinary regime of security instruments and are, therefore, held to be null and void. In States that have adopted a comprehensive and integrated regime for non-possessory security rights, transfer of title for security purposes is available but is treated as a security device. In these States, the creation, third-party effectiveness, priority and enforcement of a transfer of title for security purposes are subject to the same requirements applicable to security rights (see sect. A.4 below).

120. With respect to the treatment of transfers of title for security purposes, legislators are faced with two policy options. One option is to admit security transfers of title with the (usually) reduced requirements and the greater effects of a full transfer, thus avoiding the general regime for security rights. This option results in enhancing the secured creditor's position (although at the risk of increasing the liability of the creditor; see chapter IV on creation of a security right, para. 200 below), while weakening the position of the grantor and the grantor's other creditors.

121. The other option is to allow security transfers of title, but to limit either the requirements or the effects or both to those of a mere security right. This can be done in one of two ways. On the one hand, States could specify the transfer-of-title transactions that will be permitted, prohibiting all others, and subject these permitted devices to the creation, third-party effectiveness, priority and enforcement regime applicable to security rights. Some civil law States have taken this approach. On the other hand, States could simply provide that these security transfer-of-title transactions will be characterized as security rights. Many common law States have taken this approach. Under both these alternatives, a graduated reduction of the secured creditor's advantages and of the other parties' corresponding disadvantages is possible, especially if the requirements of a transfer of title or its effects, or both, are limited to those relating to a security right. The second alternative is the approach followed in States with an integrated, comprehensive secured transactions regime, and is also the approach recommended by this Guide (see A/CN.9/631, recommendation 11).

(b) Retention of title

122. The second method of using title as security is effected by techniques that permit sellers to use their title to tangible property being sold to a buyer as a means to secure payment of the purchase price. The most common, but not exclusive, means for doing so is through a contractual retention-of-title (reservation-of-ownership) arrangement. Nonetheless, there are several other mechanisms by which sellers may deploy title, some arising by statute and others arising by agreement between the parties.

123. In many States, the law of sale permits creditors that have actually transferred title to the buyer to seek the annulment of the sale if the buyer does not pay the price. Upon annulment, the seller may then reclaim ownership and possession of the

property free and clear of any encumbrances that the buyer may have created in it. These reclamation rights typically arise by operation of law, although in some States sellers are able to extend the reclamation right by contract beyond that provided in the law of sale. As this Guide focuses on security rights created by agreement, these statutory seller's remedies will not be discussed further here (for a more complete discussion, see chapter XII on acquisition financing rights; A/CN.9/631/Add.9).

124. In a simple retention-of-title arrangement, the seller may retain title to the goods sold until full payment of the purchase price for those goods. Lenders may also participate in such financings by accepting an assignment of the secured obligation from the seller. There are several variations on retention-of-title transactions. Sometimes, the seller merely promises to sell the property to the buyer and the sale (and transfer of title) is completed only upon full payment. Sometimes, the sale is made conditional upon the purchaser paying the full price. Most often, however, the sale is immediate, and it is only the transfer of title that is made conditional upon the buyer paying the price. The common thread to all these variations is that, even though the buyer may have possession and the use of the property (and in some cases may even have the right to dispose of the property), it does not actually obtain rights in the property until the purchase price is fully paid. Until that moment, title continues to vest in the seller.

125. States also permit variations in the scope of retention-of-title agreements. Sometimes these relate to the obligation secured and sometimes to the property that is subject to the retention of title. For example, in an "all-monies" or "current-account" retention-of-title arrangement, the seller retains title to the goods sold until all obligations owed by the buyer have been discharged, whether such obligations relate to those goods or to other goods purchased by that buyer from the seller. In an "extended" retention-of-title arrangement, the seller's rights may also extend to receivables or other proceeds arising upon the sale of the goods. However, such an arrangement exists in very few States. In any case, even in those States, the right to the proceeds generally is extinguished when the proceeds are commingled with other proceeds. In the vast majority of States, retention of title does not extend to proceeds. Also, in almost all States, retention of title extends to goods only while they retain their identity and the right is extinguished once the goods are incorporated into other goods in the manufacturing process, or otherwise lose their original identity.

126. An alternative to a retention-of-title arrangement, but with the same economic result, can be achieved by combining a lease contract with an option of the lessee to purchase the leased object at a nominal price, which may only be exercised after the lessee has paid most of the notional "purchase price" through rent instalments (see the example given in chapter II, section C.1, para. 62 above). In some cases, where the lease covers the full useful life of the leased equipment, it is equivalent to a retention-of-title arrangement even without an option to buy. These variations are all intended to function as devices to enable a borrower to finance the "acquisition" of either equipment or inventory (see chapter XII on acquisition financing rights; A/CN.9/631/Add.9). In the following paragraphs, at least with respect to leases that serve a security function, the term "seller" includes the term "lessor", and the term "buyer" includes the term "lessee".

127. Economically, a retention-of-title arrangement provides a security right that is particularly well adapted to the needs of sellers in securing credit extended for the purchase price of goods. In many States, this kind of credit, which is typically made available by suppliers, is widely used as an alternative to general bank financing and

is given preferential status in view of the importance for the economy of small- and medium-sized suppliers of goods. In other States, banks also provide acquisition financing on a more regular basis and, as a result, have developed practices that enable them to take advantage of the retention-of-title mechanism. For example, a seller can sell goods to a bank for cash and the bank then can resell the goods to the buyer on credit under a retention-of-title arrangement; or a buyer might pay the seller in cash from a loan and then transfer title to the bank as security for the loan. In those States, this source of credit and its attendant specific security is often accorded a special privilege in the form of a heightened priority over conflicting security rights in the same goods, provided that certain formal requirements are complied with.

128. Due to its origin as a term of a contract of sale or lease, many States (including a number of States that treat security transfer-of-title devices as the equivalent of security devices) still regard the retention-of-title arrangement as a mere quasi-security. As a result, they do not subject retention-of-title devices to the general rules applicable to security rights, notably as to form for creation, method of third-party effectiveness, priority and enforcement. Further advantages are that it can be created in a cost-effective way since, in many States, it is not subject to publicity. Retention of title is also well suited to short-term financing and, in some States, it gives rise to a proprietary right of the buyer. In States that permit the creation of non-possessory security rights only in certain types of asset, but not in inventory, retention of title is used for inventory financing. Another advantage is that the seller retaining title has, in many States, a privileged status. This may be justified by the desire to support normally small- and medium-sized suppliers and to promote acquisition financing by suppliers as an alternative to general bank credit.

129. At the same time, retention-of-title arrangements present certain disadvantages. The position of the buyer and the buyer's creditors is weakened and, in the absence of publicity, third parties have to rely on the buyer's representations or take the time and incur the cost to collect information from other sources. Another disadvantage is that it may prevent, or at least impede, the buyer from using the purchased assets for granting a second-ranking security to another creditor. Yet another disadvantage is that enforcement by the buyer's other creditors is impossible or difficult without the seller's consent. For these reasons, in some States retention-of-title arrangements are treated in the same way as security rights in every respect, while, in other States, they are treated as security rights in some but not in all respects (e.g. they are subject to publicity but are given a special priority status). In yet other States, retention-of-title arrangements are ineffective as against third parties in general or only if they relate to certain assets, especially inventory, on the theory that the seller's retention of title is incompatible with the seller granting to the buyer the right and power of disposition over the inventory.

130. Several policy options may be considered by States. One option is to preserve the special character of retention of title as a title device. Under this approach, retention of title would not be subject to any requirements as to form or publicity. Another, slightly different, option would be to preserve the special character of retention of title but to limit its effects to securing only the purchase price of the affected asset to the exclusion of any other credit; and to restrict it to the purchased asset to the exclusion of proceeds or products. A third option is to integrate retention-of-title arrangements into the ordinary system of security rights. In such a case, the creation, third-party effectiveness, priority and enforcement, even in the buyer's insolvency, of a retention-of-title arrangement would be subject to the same

rules applicable to security rights. Under such an approach, for the policy reasons mentioned above, it would be possible to grant the seller certain advantages (e.g. priority as of the time of the conclusion of the sales contract in which the retention of title was contained or as of the time of delivery of the goods). A fourth option might be to keep the retention of title as a separate transaction, but to place it on a par with any other security right (i.e. without granting the retention-of-title seller any special privileges relating to creation, third-party effectiveness, priority and enforcement). These options are discussed in greater detail in chapter XII on acquisition financing rights (see A/CN.9/631/Add.9).

4. Integrated and functional approach to security

131. Throughout the twentieth century, the credit demands of business were often frustrated by the lack of a suitable legal framework through which borrowers could grant security rights to lenders and other credit providers. Sometimes, the law explicitly prohibited the granting of security over certain types of asset. Sometimes, an appropriate legal device simply did not exist. Sometimes, parties were able to cobble together a legal device to serve their purposes, but it was inefficient, costly and complex to operate. These problems were at the source of many of the developments just reviewed. For example, they led to contractual practices and legislative innovations permitting fictitious “pledges” and the creation of specialized legal transactions meant to solve problems created in particular sectors of economic activity; they also stimulated the development of a variety of transfer-of-title mechanisms; and they lay behind both the extensive deployment of retention-of-title agreements and the different variations on retention of title intended to increase its efficiency as a legal device for securing the performance of an obligation.

132. Faced with the complexity, inefficiency and gaps created by this ad hoc approach to adjusting legal regimes to meet the credit needs of business, by the middle of the twentieth century some States decided to rethink the whole field of security rights in movable property. The creation of a single, integrated, comprehensive and functionally defined security right in all types of movable property was the result of this reflection. This approach to security rights was inspired by the observation that the many different types of non-possessory security right, the traditional possessory pledge and the several variations on title-transfer and retention-of-title devices were all based upon a few identical guiding principles that aimed at achieving the same functional outcomes.

133. The main theme in this new approach to security rights is that substance must prevail over form. It is no accident that this idea first developed in federal States, such as the United States of America and Canada. The United States Uniform Commercial Code, a model law now adopted by all 50 states (including the mixed common law and civil law state of Louisiana), created a single, comprehensive security right in movable property unifying numerous and diverse possessory and non-possessory rights in tangible property and intangible property, including transfer- and retention-of-title arrangements, that existed under state statutes and common law. The idea spread to Canada (including the civil law jurisdiction of Quebec), New Zealand, India and various other States (many of which are civil law jurisdictions in Central and Eastern Europe). The OAS Inter-American Model Law on Secured Transactions follows a similar approach in many respects. The EBRD Model Law on Secured Transactions follows a similar approach to the extent that it

creates a specific “security interest” which can work side by side with other security devices (e.g. leasing) and re-characterizes retention of title as a security right.

134. As an approach to creating an efficient regime that enhances the provision of low-cost credit to businesses and consumers, an integrated comprehensive security system presents certain important advantages.

135. First, all relevant statutes dealing with non-possessory security rights (which are often great in number) may be merged into one text, an approach that ensures comprehensiveness, consistency and transparency of the rules. Second, the rules on possessory security rights, especially the possessory pledge, may be covered and at the same time adapted to contemporary requirements (e.g. by introducing the notion of control in relation to security rights in intangible property). Third, title devices, such as security transfer and retention of title, may be integrated into the system in a way that not only gives sellers the protection they desire, but also enables buyers to use whatever value they have acquired in property purchased to obtain additional credit. Fourth, contractual arrangements that fulfil a security function, such as leasing contracts, sale and resale, may also be included and covered in a way that minimizes conflict and confusion about the priority of the rights of different creditors.

136. In addition, under this approach, a creditor that envisages granting a secured loan need not investigate various alternative security devices and evaluate their respective prerequisites and limits as well as advantages and disadvantages. Correspondingly, the burden borne by the grantor’s creditors, or the insolvency representative for the grantor that must consider their rights (and duties) vis-à-vis the secured creditor, is lessened if only one regime, characterized by a comprehensive security right, has to be examined rather than several different regimes. Further, this will reduce the cost of creating security rights and, concomitantly, the cost of secured credit.

137. In cross-border situations, the recognition of security rights created in assets in one State that are then moved to another State will also be facilitated if the State into which the assets are moved recognizes a comprehensive security right. Such a system can much more easily accept a broad variety of foreign security rights, whether of a narrow or an equally comprehensive character.

138. There are, however, some disadvantages to the integrated, comprehensive approach. First, this approach may require re-characterization of certain transactions (e.g. transfer of title for security purposes or retention of title), at least for the purpose of secured transactions laws. For States that do not already accept the “relativity of title” to movable property, it will be necessary to have an extensive re-education for lawyers and business people as to how such a re-characterization would operate in practice. In addition, this approach requires adjusting the basic legal logic that has heretofore underpinned the law relating to security rights in many States. In these States, security rights are conceived to be exceptions to the general principle of equality of creditors and must therefore be restrictively interpreted. Moreover, security is usually conceived as a specific right, over specific assets, to secure a specific obligation, owed by a specific debtor to a specific creditor. The integrated and comprehensive approach presumes that these traditional limitations will be displaced by a general principle favouring the spread of secured credit. Finally, this approach normally assumes that the new regime will be brought into force in a single piece of legislation. For some States this will involve

significant adjustment to the manner in which their civil codes, commercial codes or other statutes are organized.

139. Many of these disadvantages can be reduced or eliminated by careful attention to the manner in which a State chooses to develop legislation creating an integrated and comprehensive security right. For example, it would be possible to achieve most of the advantages while avoiding most of the disadvantages through (a) a comprehensive reform of existing laws relating to security rights, title devices serving security purposes, the assignment of receivables and financial leases; and (b) the enactment of specific statutory rules to regulate contractual practices that have been developed to overcome gaps in the law. In any case, the effort required to do so in a manner that would achieve consistency, transparency, efficiency and the establishment of genuine competition among all providers of credit on the basis of price would be considerable.

140. If a State were to adopt an approach that favoured the enactment of a comprehensive, integrated regime, technically either of two different approaches could be used. Under one approach, the names of the old security devices, such as pledge, floating charge, transfer of title for security purposes and retention of title, would be preserved and used. However, their creation and effects as security rights would be made subject to an integrated set of rules, even though they would continue to have their full title effects for other purposes (e.g., taxation or accounting). Under a slightly different approach, all types of rights serving security purposes would be subsumed into a unitary notion of security right and the rules applicable to certain basic types of contract that may be used for purposes of security, such as sales, leases or assignments, would be supplemented by certain specified additional rules (e.g. with respect to third-party effectiveness, priority and enforcement).

141. The Guide recommends the establishment of an integrated, comprehensive secured transactions regime as the approach that will most effectively promote secured credit. In principle, it also recommends that States adopt the second of the two techniques just presented for doing so (an approach that may be described as a functional and unitary approach). However, the Guide also recognizes that some States may not be in a position to adopt the functional and unitary approach to acquisition financing rights and therefore contemplates that, in this particular situation, States might choose to adopt the first approach to achieving a comprehensive and integrated regime, an approach that might be characterized as a functional and non-unitary approach (for a more detailed discussion, see chapter XII on acquisition financing rights; A/CN.9/631/Add.9).

B. Recommendations

[Note to the Commission: The Commission may wish to note that, as document A/CN.9/631 includes a consolidated set of the recommendations of the draft legislative guide on secured transactions, the recommendations are not reproduced here. Once the recommendations are finalized, they will be reproduced at the end of each chapter.]

IV. Creation of a security right (effectiveness as between the parties)

A. General remarks

1. Introduction

142. A security right under the Guide is a property right (as opposed to a personal right) in movable property (as opposed to immovable property) created by agreement (as opposed to statutory or judgement rights) between the grantor and the secured creditor that is meant to secure the performance of an obligation owed by the grantor or another person to that creditor (for the definition of “security right”, see para. 19 above). A key issue, therefore, is to determine the steps necessary for a security right to become fully effective between the parties and as against third parties.

143. In some States, a fully effective security right in an asset only comes into being upon conclusion of a security agreement and completion of an additional act, such as delivery of possession of the encumbered asset. Depending on the nature of the asset, notification of a third party may be required (as in the case of receivables) or registration (as in the case of ships or aircraft). Until these acts have occurred, the security right is not considered as having been created and is not, therefore effective, even as between the parties. However, once these acts have occurred, the security right is effective not only as between the parties, but also as against any person whether party to the security agreement or not (this is often referred to as the *erga omnes* effect of property rights).

144. In other States, a distinction is made between the effectiveness of a security right as between the parties (*inter partes*) and its effectiveness as against third parties. The security right comes into existence upon conclusion of the security agreement, but is effective only as between the parties. An additional act is required for the security right to become effective against third parties. This additional act also serves as a basis for determining the priority of the security right as against competing claimants (for the definitions of “competing claimant” and “priority”, see para. 19 above). The main advantage of this approach is practical, making it possible for a grantor to offer the same assets as security to more than one creditor (thereby increasing the amount of credit that a grantor can obtain based upon the value of the assets), while creating a basis for determining the priority ranking of those creditors.

145. This approach is based on the idea that a security right has two distinct elements. There is, first, a relationship between the parties; and there is, second, a property element to the security that will produce effects that directly affect the rights of third parties. In other words, the security agreement is sufficient for the security right to be effective as between the parties, but insufficient to establish effectiveness against third parties, such as other secured creditors, judgement creditors or the insolvency representative in the insolvency of the grantor. Furthermore, this approach is based on the assumption that there is no need to subject effectiveness as between the parties to notification or registration and, to the contrary, such an approach could create an obstacle to transactions that serve security purposes but are based on informal sale or lease techniques (e.g. retention-of-title sales, financial leases or hire-purchase agreements).

146. Some States adopt a third approach, which is a hybrid between the first two approaches. It involves treating a security right as effective against all upon its creation (including the grantor's unsecured creditors, judgement creditors, the grantor's insolvency representative, donees and transferees of encumbered assets outside the ordinary course of business of the grantor), but provides for the application of special rules of third-party effectiveness and priority in the case of competing claimants that assert specific rights in the encumbered assets (e.g. competing secured creditors or transferees of encumbered assets in the ordinary course of business). This approach generally leads to the same results as the second approach, with a slight variation in relation to the rights of certain creditors, such as unsecured creditors, judgement creditors and the insolvency representative (see A/CN.9/631/Add.2, paras. [...]).

147. This Guide adopts the second of the three general approaches to creation and effectiveness of security rights just reviewed. That is, it recommends an approach that distinguishes between the requirements necessary for a security right to be effective as between the parties and those necessary for parties to achieve third-party effectiveness of the security right (see paras. 144 and 145 above). This chapter deals with issues relating to the creation of a security right in an asset by agreement and its effectiveness as between the parties to the security agreement. The effectiveness of a security right against third parties is discussed in chapter V on effectiveness against third parties (see A/CN.9/631/Add.2). The rules for the priority ranking of creditors with claims in the same assets are discussed in chapter VII on priority (see A/CN.9/631/Add.4). Matters related to the effectiveness of a security right in the case of insolvency are discussed in chapter XI on insolvency (see A/CN.9/631/Add.8).

2. Creation of a security right

148. Two separate issues must be addressed in a consideration of the creation of a security right and its effectiveness as between the grantor and the secured creditor. Most importantly, there is the question of creation, that is, when and under what conditions a security right is created. There is also the question of effectiveness as between the parties generally, that is, when and under what conditions a security right becomes effective between the parties. Normally these two questions have the same answer. When the steps for creation of a security right have been accomplished, it becomes effective as between the parties at that moment. However, it may be that a security right that has been created later ceases to be effective as between the parties. In such cases, it is important to determine exactly when the right has ceased to be effective even as between the parties. These two facets of the question are considered in turn.

149. In most States, the creation of a security right in movable property requires that an agreement (for the definition of "security agreement", see para. 19 above) between the grantor and the secured creditor providing for such creation be concluded (see A/CN.9/631, recommendation 12).

150. The security agreement may fulfil several functions, including (a) providing the legal basis for granting a security right; (b) establishing the connection between the security right and the obligation it secures; (c) generally regulating the relationship between the grantor and the secured creditor (for pre-default rights, see chapter VIII; A/CN.9/631/Add.5); and (d) minimizing the risk of disputes with respect to the contents of the security agreement and the risk of manipulation after default (for post-default rights, see chapter X, A/CN.9/631/Add.7).

151. While the security agreement sometimes may be a separate agreement between the parties, often it is contained in the underlying financing contract or other similar contract between the grantor and the secured creditor, such as a contract for the sale of goods on credit.

152. As previously noted, in many States, the security agreement is itself sufficient to create the security right as between the grantor and the secured creditor. In other States, however, in addition to the security agreement, another act is required for a security right to be created even as between the parties (i.e. transfer of possession, notification or registration). What that act might be varies from State to State, and even within individual States, according to the type of security right or asset involved.

153. Certain agreements relating to title to movable property may serve security purposes. These include, for example, a seller's retention of title, transfer of title for security purposes, assignment of receivables for security purposes, as well as sale and resale, sale and leaseback and hire-purchase and financial lease (for the definitions of "assignment", "financial lease" and "retention-of-title right", see para. 19 above).

154. In legal systems with a comprehensive and integrated secured transactions regime, title-based devices that serve security purposes are generally required to be created in the same way as any other security right. They are either replaced by a uniform notion of security right or, while their various terms are preserved, the specific requirements necessary for their creation as between the parties are the same as those applicable to security rights

155. In other legal systems, title-based devices are the main mechanism by which non-possessory security rights may be created. In such States, title devices are usually regulated according to the rules applicable to the specific transaction by which title is meant to pass between the parties (e.g. a sale, an exchange, a lease with option to purchase and so on). Sometimes, given their function as security, these transactional rules are also overlain with various statutory and court developed rules. The detail of the regimes in legal systems that preserve the specificity of title devices can differ widely from State to State. In some legal systems, only retention of title is subject to a specific regime, while transfer of title for security purposes from a borrower to a lender and the assignment of receivables for security purposes are subject to the same rules governing the creation of security rights. In other legal systems, some transfer of title devices, such as a sale with a right of redemption, are also subjected to a specific regime in the same manner as retention-of-title devices.

156. The treatment of retention-of-title devices is a key indicator of how a legal system generally conceives of title-based security. Legal systems that do not treat title-based devices as constituting security rights usually place particular emphasis on retention of title, even though they can have quite different requirements for the creation of retention-of-title devices. That is, in these systems, retention of title is used widely and is effective as against all parties. In other legal systems, however, retention of title plays an insignificant role and is generally ineffective, or at least ineffective as against the insolvency representative in the buyer's insolvency. One point on which many legal systems converge is that only simple retention-of-title agreements are treated as a genuine title device, while agreements that contain all-sums clauses or proceeds and products clauses are treated as true security devices. Another point on which many legal systems converge is that only the seller may retain title. Other suppliers of credit may benefit from a retention of title only

if they receive an assignment of the outstanding balance of the purchase price from the seller (see chapter XII on acquisition financing rights; A/CN.9/631/Add.9).

157. In most legal systems that recognize retention of title, the seller's rights derive from a clause in the sale agreement. In a few States, retention of title is presumed in all sales on credit and the seller's retention right need not even be explicitly stated in the sale agreement. In other States, the contractual right of retention may be concluded between the parties even orally or by reference to printed general terms in a supply document or invoice. In still other legal systems, some type of writing, a certain date for the agreement and even registration may be required.

158. Legal systems also differ substantially in the terminology used and the requirements for transfers of title for security purposes. For example, these can be called fiduciary transfers of title for security purposes, sales with a right to reclaim, double sales and sale-leaseback with an option to purchase. A first point to note is that, in some legal systems, a security transfer of title is void as against third parties, and occasionally even as between the transferor and the transferee. In other legal systems, while a security transfer of title is effective, it is not widely used in view of the existence of other non-possessory security rights. In most of the legal systems that recognize the security transfer of title, the rules with respect to its creation are the same as those applicable to secured transactions in general or at least in the case of the transferor's insolvency. So, for example, a sale with a right to reclaim or a double sale will usually be with respect to the form and content of the agreement subject to the same rules as those applicable to secured transactions.

159. Many legal systems also recognize that transactions built around the idea of a lease (hire-purchase and financial lease in the context of acquisition financing and sale-leaseback in the context of a lending transaction) often perform security functions. In some legal systems, they are treated as security devices and the requirements for their creation and effectiveness as between the parties are those applicable to all other security devices. In other legal systems, they are treated not as security devices but as contractual arrangements creating personal rights. In these legal systems, the requirements for their creation will normally be those applicable to the creation of a contractual right of that type as between the parties.

160. The second issue that States face when deciding the basic requirements for the creation of a security right is to determine when the security right actually becomes effective between the parties. In most States, because the security right arises from an agreement between the parties, it becomes effective between them as soon as it is concluded. The parties may, of course, agree to defer the effectiveness of the security right to a later time, but normally do not do so (in any case, they cannot agree to a time earlier than the time of the conclusion of the agreement). It is also necessary to determine when the security right begins to affect the assets that are encumbered. Here a distinction must be drawn between present assets of the grantor and future assets. Where the security agreement provides for the creation of a security right in assets with respect to which the grantor has rights, or the power to encumber, at the time the security agreement is concluded, the security right is effective between the parties in relation to those assets as of that time, subject to any agreement between the parties to defer effectiveness in respect of some or all those assets. Where, however, the security agreement provides for the creation of a security right in assets with respect to which the grantor expects to acquire rights, or the power to encumber, in the future, the security right is effective between the parties in relation to those assets only from the time the grantor acquires such rights

or the right to encumber, unless of course, the parties agree to postpone the date of effectiveness (see A/CN.9/631, recommendation 12; see also para. 185 below).

3. Essential elements of a security agreement

161. Legal systems differ as to the essential elements that a security agreement must contain in order to be effective between the parties. Certain elements are, however, common to most legal systems. Typically, States require that the security agreement must (a) identify the parties; (b) state the obligation to be secured; and (c) describe the assets to be encumbered. Some States also impose a requirement that the security agreement set out the maximum amount for which the security right may be claimed in the encumbered assets.

162. The degree of specificity required for identification of the secured obligation and the encumbered assets varies from State to State. The advantage of a specific description is certainty, but the disadvantage is inflexibility to address important financing transactions involving changing amounts of secured obligations and a changing pool of encumbered assets, including after-acquired assets (such as, for example, revolving credit facilities relating to inventory or receivables). In any case, whether or not legislation lists the identification of the parties and the description of the obligation to be secured and the assets to be encumbered as the minimum contents of a security agreement, failure to deal with them in the security agreement may result in disputes concerning the scope of the assets encumbered and the obligation secured, unless the missing elements may be established through other means.

163. The parties to the security agreement may also use it to clarify additional matters, such as the duty of care on the part of the party in possession of the encumbered assets and representations with respect to the encumbered assets. In the absence of an agreement, default rules may apply to clarify the relationship between the parties (for pre-default issues, see chapter VIII, A/CN.9/631/Add.5; for post-default issues, see chapter X, A/CN.9/631/Add.7).

164. Many modern secured transactions regimes refrain from adopting elaborate requirements for the effectiveness of a security agreement and instead reflect the view that the promotion of secured credit is facilitated by providing that an agreement may be effective if it meets certain minimal requirements, such as (a) reflecting the intent of the parties to create a security right; (b) identifying the parties (e.g. the grantor and secured creditor); (c) describing the obligation to be secured by the security right; and (d) describing the assets to be encumbered (see A/CN.9/631, recommendation 13).

165. As more fully discussed below (see paras. 188-190), the Guide takes the position that a generic description of the encumbered assets is sufficient, such as “all present and future assets” or “all present and future inventory”.

4. Form of a security agreement

166. Legal systems also take different positions as to the form requirements for security agreements and the function of these requirements. In particular, some legal systems do not require that there be a written security agreement, while other legal systems require some kind of writing. In a few States, a simple, unsigned writing is sufficient. In other States, a signed writing is required. In yet other States, the security agreement must be in a notarized writing or an equivalent document.

Normally, written form performs the function of a warning to the parties of the legal consequences of their agreement, of evidence of the agreement and, in the case of authenticated documents, of protection for third parties against fraudulent antedating of the security agreement. Written form may also serve other purposes besides being a condition of effectiveness as between the parties. For example, in many States it is a condition of effectiveness as against third parties, or of priority among competing claimants. In many of these States, written form may also be a condition for obtaining possession of the encumbered assets or for invoking the security agreement in the case of enforcement, within or outside insolvency.

167. In some legal systems, a certification of the date by a public authority is required for possessory security rights, with the exception of small-amount loans where proof by way of witnesses is permitted. While such certification may address the problem of fraudulent antedating, it may raise a problem with respect to the time and cost required for a transaction. In other legal systems, a certified date or authentication of the security agreement is required for various types of non-possessory security (see, for example, articles 65, 70, 94 and 101 of the Uniform Act Organizing Securities of the Organization for Harmonization of Business Law in Africa). In some of those systems, such certification is required instead of registration. Where, however, registration is necessary, an additional certification of the date of the security agreement is not required.

168. In many legal systems, in the interest of saving time and cost, mandatory form requirements are kept to a minimum. A simple writing (including, for example, general terms and conditions on an invoice) is sufficient as long as it, either alone or in conjunction with the course of conduct of the parties, indicates the intention of the grantor to grant a security right. Consistent with the idea of simplifying as much as possible the process for creating a security right, which is one of the key objectives of the Guide (see para. 23 above), this is the position of the Guide (see A/CN.9/631, recommendations 1, subpara. (c), and 14). Writing includes an electronic communication (see A/CN.9/631, recommendation 9). The one exception to the above rules is that the security agreement may be oral if accompanied by a transfer of possession of the encumbered asset to the secured creditor (see A/CN.9/631, recommendation 14). However, if the security right is created by oral agreement and transfer of possession, and later the secured creditor relinquishes possession, a written agreement is necessary for the security right to continue to exist.

[Note to the Commission: The Commission may wish to consider revising recommendation 14 to clarify that, if the secured creditor relinquishes possession of an encumbered asset in which a security right was created by oral agreement and transfer of possession, a written agreement is necessary for the security right to continue to exist.]

169. The security agreement is typically concluded between the debtor as grantor of the security right and the secured creditor. Occasionally, if a third person grants the security for the benefit of the debtor, this person becomes a party to the agreement instead of, or in addition to, the debtor. In the case of large loans granted collectively by several lenders (especially in the case of syndicated loans), a third party, acting as agent or trustee for the lenders, may hold security rights on behalf of all of the lenders. Security agreements may be tailored to cover each of these situations. While some systems introduce limitations (e.g. only enterprises may grant an enterprise mortgage), in other systems both natural and legal persons may be parties to a security agreement.

5. Obligations subject to a security agreement

170. Security rights are accessory to, and dependent upon, the obligation they secure. This means that the validity and the terms of the security agreement depend on the validity and the terms of the agreement establishing the secured obligation. In particular, with respect to revolving loan transactions a security right is accessory in the sense that, while it can secure future advances and fluctuating obligations, it cannot be enforced if there is no advance on the loan and cannot surpass the amount of the obligation owed at the time of enforcement.

171. In some States, non-possessory security rights may relate only to specific types of obligation described in legislation (e.g. loans for the purchase of automobiles or loans to farmers). In other States with a general regime for possessory security rights only or for both possessory and non-possessory security rights, no such limitations exist. Such a comprehensive approach (see A/CN.9/631, recommendation 15) has the potential of spreading the main benefits derived from secured financing (i.e. greater availability and lower cost of credit) to a wide range of transactions. In addition, such an approach enhances consistency and equal treatment of all debtors and secured creditors. To the extent such special regimes are necessary for specific socio-economic reasons, adverse effects may be minimized if such regimes are established in a clear and transparent way and are limited to a narrow range of transactions.

172. States that do not link certain forms of security to certain types of obligation typically do not limit the types of obligation for which a security right may be granted. Moreover, unless there is a special regime for security rights in specific types of obligation (e.g. for loans by pawnbrokers), States usually do it to list in legislation all the types of obligation that can be secured. Given the pace at which new types of credit obligations are being created, it would be impossible to enact an exhaustive list that would not quickly be out of date. It is, however, common for States to provide an indicative list. Such a list would typically include obligations arising from loans and the purchase of goods, including inventory and equipment, on credit.

173. Legal systems take different positions on whether, and to what extent, a security agreement may be created to secure future obligations. They also differ on the definition of what a future obligation actually is. In some systems, future obligations are the obligations that have not been contracted for (this is the approach of the United Nations Assignment Convention; see article 5, subpara. (b)). In other systems, even obligations that have been contracted for but are not due at the time of the security agreement (because the loan has not yet been advanced or the loan involves a revolving loan facility) are treated as future obligations. In addition, obligations subject to a condition subsequent are invariably treated as present obligations, while obligations subject to a condition precedent are normally treated as future obligations.

174. The distinction between present and future obligations is significant in those legal systems in which, for reasons of certainty and debtor protection, future obligations may not be capable of being secured or may be secured only up to a maximum amount, or may not be secured if they are indeterminate (e.g. where the security agreement purports to cover “all present and future obligations of whatever type that may arise between the parties”). In States that impose limits on granting security rights to secure future obligations, debtors may not be able to benefit from certain transactions, such as revolving loan facilities or convertible term loans.

In other legal systems, future obligations may be freely secured. In these systems, one security agreement is sufficient to cover both present and future obligations. As a result, each extension or increase of credit does not require that the corresponding security right be modified or even newly created, and this has a positive impact on the availability and the cost of credit. While a security right may be created in a future obligation, it cannot be enforced until the obligation arises and becomes due. Some States impose various requirements as to the manner in which the type and amount of the secured obligation may be stated.

175. In some legal systems, it is necessary for the parties to describe the secured obligations in their agreement in specific terms to set a maximum limit to the amount for which the asset can be encumbered as security for the secured obligation, or even to reduce the amount of the security to reflect the current balance owed on that obligation. The assumption is that such a description or limit is in the interest of the debtor since the debtor would be protected from over-indebtedness and would have the option of obtaining additional credit from another party. However, such requirements may result in limiting the amount of credit available from the initial creditor or may lead creditors to indicate an amount well in excess of the actual amount that they agree to advance to the grantor. The result often is, consequently, that the grantor is deprived of the ability to use the full value of its assets to secure either additional obligations to its present creditor or new obligations contracted with other creditors.

176. Modern financing transactions often no longer involve a one-time payment but instead frequently foresee advances being made at different points of time depending on the needs of the grantor (for example, revolving credit facilities for the grantor to buy inventory). Such financing may be conducted on the basis of a current account, the balance of which fluctuates daily. If the amount of the secured obligation were to be reduced by each payment made, lenders would be discouraged from making further advances unless they were granted additional security. This would be highly inefficient as it would add to the cost and the time necessary for the grantor to acquire new goods required for the conduct of its business. Finally, a few States attempt to control credit by imposing limits on the amount for which an asset may be encumbered, calculated as a percentage of the credit advanced to the grantor (e.g. 125 per cent of the obligation owed). These types of legislative limit as to the amount to be secured are unavoidably arbitrary, usually cannot be fine-tuned to meet the credit needs of individual grantors and would normally need to be adjusted constantly to reflect changes in the credit relationship between the grantor and the secured creditor.

177. For all of the above reasons, many legal systems do not require specific descriptions of the secured obligations and allow parties to negotiate freely the amount to be secured, including all sums owed by the debtor to the secured creditor. In those legal systems, the secured obligation must be determined or determinable on the basis of the security agreement whenever a determination is needed (as is the case, for example, when the secured creditor enforces its security rights). Moreover, the grantor is protected because the secured creditor cannot claim from the encumbered assets more than it is owed and, if the obligation is fully secured, better credit terms are likely to be offered to the grantor by the secured creditor.

178. States also take different positions as to whether the actual amount of the secured obligation (including the rate of interest, if any) must be stated in the security agreement itself and whether that amount must be expressed in a currency and, if so, in what currency it must be expressed. For example, some States require

that the security agreement indicate not only the type of obligation being secured but also its amount (e.g. the actual amount of the credit being provided). Other States require only that the type of obligation be stated and leave the details to the loan or credit agreement. In addition some States require the obligation to be expressed in a currency, while others permit the parties to express the repayment obligation however they wish. Today, many States do not impose any restrictions on the currency in which the amount of the secured obligation may be expressed beyond those applicable to obligations generally.

179. Where there is debtor default (or insolvency) and disposition of the encumbered assets, the proceeds may be paid in a currency (for example, dollars) different from the currency (for example, euros) in which the secured obligation is expressed. In such cases, it will be necessary to convert the proceeds from the disposition of the encumbered assets so that the secured obligation and the encumbered assets are expressed in the same currency. This issue, however, is typically left to the contract from which the secured obligation arises and to the applicable law (e.g. in the absence of an agreement, the exchange rate prevailing at the place of enforcement or insolvency proceedings will prevail).

6. Assets subject to a security agreement

180. A central aspect of the security agreement is the identification of the assets that will be subject to the security right. States typically are required to address four separate issues when determining how the assets that may be subject to the security right should be identified. First is the question of whether security may be granted in property not owned, or not yet owned, by the grantor. Second is the question of whether certain types of asset should not be susceptible of encumbrance by a security right. Third is the question as to how the assets may be described (i.e. whether they must be described individually or they may be described generically). Finally, States have to decide whether a grantor should be permitted to create a security right that generally covers all its assets (i.e. an agreement that in many States takes the form of an “enterprise mortgage”).

(a) Future assets

181. In most legal systems, the grantor of the security has to be the owner of the assets to be encumbered or have some limited proprietary right (e.g. a right of use) in the encumbered assets. That is, the security agreement cannot be concluded until the grantor actually has rights in the assets that the agreement purports to cover. This immediately raises the question as to whether the security agreement can be concluded so as to cover (a) assets in which the grantor has only a contractual right (for example, in many legal systems a lessee has no proprietary rights in leased property); and (b) future assets (for example, assets that the grantor is in the process of acquiring or intends to acquire, but that still belong to the seller, or assets that will be manufactured in the future from raw materials that may or may not already be owned by the grantor — i.e. do not even exist yet).

182. In addressing these issues, most States start from the principle that the grantor cannot grant to the secured creditor more rights than the grantor has or may acquire in the future (*nemo dat quod non habet*). This means, for example, that, if the grantor has only a contractual right to use an asset, any security right that it grants can only affect its contractual right. A lessee may only grant security in the lease agreement and not directly in the object being leased. Subject to rules that States

adopt concerning the detail required for describing the encumbered asset, this means that the agreement must identify that asset as a lease, not as the leased object itself. Similarly, it means that if the grantor only has a limited right in the property (for example, a usufruct) the security right will only encumber the right of usufruct. Increasingly, however, States are confronted with the question of whether “future” assets may be covered by a security agreement.

183. In some States, future assets of whatever kind may not be used as security. This approach is partly based upon technical notions of property law (e.g. what does not exist cannot be transferred or encumbered). It is also based on the concern that allowing broad dispositions of future assets may inadvertently result in over-indebtedness and in making the grantor excessively dependent on one creditor, preventing the grantor from obtaining additional secured credit from other sources. Another argument offered for not permitting the creation of security rights in future assets is that permitting it may significantly reduce the possibility that unsecured creditors of the grantor will obtain satisfaction for their claims. However, technical notions of property law should not be invoked to pose obstacles to meeting the practical need of using future assets as security to obtain credit. In addition, business grantors can protect their own interests and do not need statutory limitations on the transferability of rights in future assets. Moreover, permitting future assets to be encumbered makes it possible for grantors with insufficient present assets to obtain credit, which is likely to enhance their business and benefit all creditors, including unsecured creditors.

184. In other States, the parties may agree to create a security right in a future asset. The disposition is a present one but it becomes effective as to the future asset only when the grantor becomes the owner of the asset or the asset comes into existence. The United Nations Assignment Convention takes this approach (see art. 8, para. 2, and art. 2, para. (a)). Permitting the use of future assets as security for credit is important, in particular, for securing claims arising under revolving loan transactions with a revolving pool of assets. Assets to which this technique is typically applied include inventory, which by its nature is to be sold and replaced, and receivables, which after collection are replaced by new receivables. The main advantage of this approach is that one security agreement may cover a changing pool of assets that fit the description in the security agreement. Otherwise, it would be necessary to continually amend security agreements or enter into new ones, a result that could increase transaction costs and decrease the amount of credit available, in particular on the basis of revolving credit facilities.

185. The Guide takes the position that a security agreement may cover future assets. Where the security agreement provides for the creation of a security right in assets with respect to which the grantor has rights, or the power to encumber, at the time the security agreement is concluded, the security right in those assets is created at the time the security agreement is concluded. Where, however, the security agreement provides for the creation of a security right in assets with respect to which the grantor expects to acquire rights, or the power to encumber, in the future, the security right is created if and when the grantor acquires such rights or right to encumber (see A/CN.9/631, recommendations 12 and 16).

(b) Excluded assets

186. In some legal systems, special laws for specific types of non-possessory security right introduce limitations as to the types of asset that may serve as security or as to the part of the value of assets that may be encumbered. Examples of

limitations justified for public policy reasons may include employment benefits (e.g. wages and pensions) under a certain minimum amount. In other legal systems, limitations are placed on the purposes for which certain classes of grantors may grant security. For example, some States do not permit grantors to create security over household goods unless the security right is created to secure payment of the purchase price of those assets. Still other States limit the capacity of certain grantors to create certain types of security right. For example, in some legal systems, persons not carrying on a business are prevented from granting non-possessory security rights and may only pledge their assets. In other legal systems, these same persons are not permitted to grant a security right in future assets or a security right in a category of assets. Security rights may be created only in existing assets and only where those assets are described individually.

187. All these limitations, which are usually intended to protect grantors, also prevent grantors from utilizing the full value of their assets to obtain credit. Therefore, the benefits and the negative impact of such limitations need to be carefully weighed. Some States undertake this necessary balancing not by including such limitations in the general legislation establishing the regime of security rights, but by elaborating specific rules setting out appropriate limitations on the creation of security rights in special legislation such as consumer-protection legislation. This approach has the advantage of enabling States to design the limitations in a targeted manner that furthers policy objectives directly related to the protection of those grantors deemed in need of such protection.

(c) Identification of assets

188. In some legal systems, the encumbered assets need to be specifically identified. While such a requirement is intended to protect the grantor from granting excessive security rights, it also limits availability of credit in many cases. For example, specific identification of individual items may not be practical or even possible for assets such as inventory and, to some degree, receivables. To address this issue, many States have developed rules that allow the parties to describe the assets to be encumbered only in general terms. The specific identification, generally required, is transposed from the individual items to an aggregate, which in turn has to be generally identified.

189. These general descriptions can take many forms. For example, parties may provide that the security right encumbers “all inventory”, or “all inventory in warehouse ABC”, or “all sailboats and canoes”, or “all cows”, or “all printing presses” or “all receivables”. The key is neither the type of asset (equipment, inventory, receivables) nor the extent or scope of the category (“all assets in ‘X’ location” or “all sailboats and canoes” as opposed to “all watercraft”). Rather, States that permit general descriptions simply require that the description be sufficient to enable third parties to know, at any given time, what assets are encumbered by the security agreement.

190. In some legal systems, it is possible to identify encumbered assets with a description cast at a very high level of generality. In these States, even a description referring to “all assets”, or “all present and future inventory”, is sufficient. The goal is to reduce the complexity and cost of creating a security right by permitting the parties to describe the encumbered assets in the simplest language possible. As noted, however, in many of those legal systems which permit identification by reference to a category of assets, such a generic identification of encumbered assets is not allowed with respect to assets of consumers or even individual small traders.

Subject to ensuring that the identification of encumbered assets is sufficiently clear and to public policy limitations that States may desire to impose for consumer-protection purposes, this Guide recommends that general descriptions of both present and future inventory be permitted (see A/CN.9/631, recommendations 13 and 16).

(d) Security in all assets of a grantor

191. Some States, as just mentioned, do not permit grantors to create a security right in assets that are described in general terms. By contrast, many other States do. Nonetheless, even in some legal systems that permit the general identification of categories of encumbered assets and even permit a general identification of present and future assets, grantors are often not permitted to create a security right in all of their assets (that is, in even “all present and future assets”). In other legal systems, grantors are permitted to create a security right in all of their assets, but only up to a certain percentage of their total value. Such limitations, which are intended to provide some protection for grantors and unsecured creditors, are bound to limit the credit available and increase the cost of credit.

192. In order to enhance the availability of secured credit, some legal systems impose no such limitations. Grantors are permitted to create a non-possessory security right in all of their assets, including tangible and intangible, movable and immovable (although different rules may apply to security in immovable property), and present and future assets. The most essential aspects of such an all-asset security right are, first, that it covers all assets of a grantor in a single security agreement, and second, that the grantor has the right to dispose of certain of its encumbered assets (such as inventory) in the ordinary course of its business (while the security is extended automatically to the proceeds of the disposed assets). States take different approaches as to both of these aspects of all-asset security rights.

193. In many legal systems, the essential elements both as to content and as to form for the creation of a security right covering all assets are more onerous than those applicable to ordinary security rights. In other legal systems, as long as no immovable property is encumbered by the security agreement, the requirements for creating the security right are identical to those for ordinary security rights. Where immovable property is also encumbered, it is necessary that the agreement respect the substantive and formal requirements for creation of an encumbrance in immovable property. As for the grantor’s right to dispose of encumbered assets without affecting the security right, most legal systems provide that the grantor may do so with the permission of the secured creditor. Some legal systems provide that, in such cases, the security right no longer encumbers the asset, while others provide that the security right still affects the asset. However, in some legal systems, dispositions of encumbered assets by the grantor, even if authorized by the creditor, are regarded as irreconcilable with the idea of a security right. In order to simplify the creation of a security right in all assets of an enterprise, where the provider of credit is financing the ongoing operation of the enterprise, this Guide recommends that single-document all-asset security agreements be permitted (see A/CN.9/631, recommendation 16).

(i) Enterprise mortgages

194. The concept of “all-asset security rights” is not novel. In some States, the idea of an all asset-security right has long existed in the form of what is often called an “enterprise mortgage”. Like an all-asset security right, an enterprise mortgage may

comprise all assets of an enterprise (including, in some States, even immovable property). It may cover, for example, incoming cash, new inventory and equipment, as well as future assets of an enterprise, while present assets that are disposed of in the ordinary course of business are released. The main advantage of an enterprise mortgage is that it allows an enterprise that has more value as a whole to obtain more credit and at a lower cost. An interesting feature of some forms of enterprise mortgage is that upon enforcement by the secured creditor and upon execution by another creditor, an administrator can be appointed for the enterprise. This may assist in avoiding liquidation and in facilitating reorganization of the enterprise with beneficial effects for creditors, the workforce and the economy in general. In practice, however, administrators appointed by the secured creditor may favour the secured creditor. This problem may be mitigated to some extent if the administrator is appointed and supervised by a court or other authority. This feature of an enterprise mortgage may be usefully expanded to all-asset security rights in the sense that the administrator could be appointed by agreement of the grantor and the secured creditor or by the court and be responsible for enforcement outside insolvency.

195. Enterprise mortgages may present certain disadvantages in practice. One disadvantage is that the secured creditor usually is or becomes the enterprise's major or even exclusive credit provider and this may affect competition among credit providers and thus negatively affect the availability and the cost of credit to the extent that other creditors are unprotected (although competition is not necessarily precluded since a single major credit provider may offer particularly competitive credit terms). In order to address this problem, some States have introduced limitations on the scope of enterprise mortgages, preserving a percentage of the value of the enterprise for unsecured creditors in the case of insolvency. However, such limitations may have an adverse impact on the availability of credit by effectively reducing the value of assets available to serve as security for credit. Another possible disadvantage of enterprise mortgages is that, in practice, the holder of the mortgage may fail to monitor sufficiently the enterprise's business activities and to participate actively in reorganization proceedings since the mortgagee is amply secured. In order to counterbalance the mortgagee's overly strong position, the debtor-enterprise may be given a claim for the release of grossly excessive security.

(ii) *Floating charges*

196. In other States, all-asset security rights take the form of a so-called "floating charge" that is merely a potential security right with a right for the grantor to dispose of certain of the encumbered assets (such as inventory) in the ordinary course of business. Dispositions are barred as of the time the debtor is in default, when the floating charge "crystallizes" to become a fully effective "fixed" charge. Once a legal system permits the creation of non-possessory security rights in all assets of a grantor while the grantor is allowed to dispose of certain of the assets in the ordinary course of its business, there is no need to preserve the construction or the terminology of enterprise mortgages or floating charges (see also para. 199 below).

(iii) *Over-collateralization*

197. Related to, though distinguishable from, concerns about all-asset security is the issue of over-collateralization. The problem of over-collateralization arises in

situations where the value of the encumbered assets significantly exceeds the amount of the secured obligation. While the secured creditor cannot claim more than the secured obligation plus interest and expenses (and perhaps damages), over-collateralization may create problems. The grantor's assets may be encumbered to an extent that makes it difficult or even impossible (at least in the absence of a subordination agreement between creditors) for the grantor to obtain a second-ranking security from another creditor. In addition, enforcement by the grantor's unsecured creditors may be precluded or at least be made more difficult (unless there is excess value).

198. A solution developed by courts in some States is to declare any security right grossly in excess of the secured obligation plus interest, expenses and damages void or to grant the grantor a claim for release of such excess security. This solution could work in practice, if a commercially adequate margin may be determined and granted to the secured creditor, which may not be easy in all cases. While the problem of over-collateralization is, in many cases, a real concern, the appropriate response to the concern is likely to vary from State to State and may sometimes lie in regulation of these practices in other law. For this reason, the Guide does not recommend adoption of the concept of a judicial declaration of over-collateralization (with a consequent reduction of the scope of the encumbered assets) as a solution.

(iv) *Conclusion*

199. Once a legal system permits the creation of non-possessory security rights in all present and future assets of a grantor under a regime that permits the grantor to dispose of certain of the assets in the ordinary course of its business, many of the particular devices that States have designed to permit businesses to obtain credit by granting security rights over the enterprise as a whole are no longer necessary. That is, concepts and terms like "enterprise mortgages" and "floating charges" were important because they performed a role in business financing that regular security rights were not able to accomplish. However, where States opt to create integrated and functionally organized regimes for the granting of security and enable grantors to encumber all their present and future assets in the same agreement, the need for these existing devices is significantly reduced, if not eliminated. While the Guide does not recommend that States dispense with "enterprise mortgages" and "floating charges", as noted it does recommend that States adopt the concept of all-asset security rights, which performs the functions performed by those other devices (see A/CN.9/631, recommendation 16).

(e) **Liability of the secured creditor for loss or damage caused by the encumbered assets**

200. While liability for loss or damage caused by encumbered assets (as a result of breach of contract or tort) is not a secured transactions issue, it is important that it be addressed since it may have an impact on the availability and the cost of credit. A particularly important issue is liability for environmental damage caused by assets subject to possessory or non-possessory security rights, since the monetary consequences and the prejudice to the reputation of the lender may substantially exceed the value of the encumbered assets. Some laws expressly exempt secured creditors from liability, while other laws limit such liability under certain conditions (e.g. where the secured creditor has no possession or control of the encumbered asset). When no such exemptions from or limitations of liability exist, the risk may

be too high for a lender to extend credit. Where insurance is available, it is bound to substantially increase the cost of credit.

7. Creation of a security right in proceeds

(a) Concept of proceeds

201. A characteristic feature of movable property is the fact that it is often made in order to be sold, leased or licensed. When encumbered assets are sold, exchanged or otherwise disposed of, or leased or licensed during the time in which the obligation they secure is outstanding, the grantor typically receives, in exchange for those assets, cash, tangible property (e.g. goods or negotiable instruments) or intangible property (e.g. receivables). This being the case, States must determine whether a security right that is taken in the initial property should extend to new property that is received in exchange for that property when it is sold or disposed of. So, for example, States are required to decide whether a security right in a piece of equipment like a printing press extends into the money that is received by the grantor when it sells the printing press, or into another printing press that is received in exchange for the press that has been sold. In the terminology of property law, such cash or other tangible or intangible property received in exchange upon a sale or other transfer is considered to be “proceeds of disposition”. Once again, for the purposes of secured transactions law, it is often much less important whether the property received upon disposition is another object, cash, a receivable or a negotiable instrument. What matters is whether the security right may extend to this new property.

202. In some cases, the proceeds of the originally encumbered assets may generate other proceeds when the grantor disposes of the original proceeds in return for other property. Such proceeds are sometimes referred to as “proceeds of proceeds”. If there is a right in proceeds of encumbered assets, it should extend to proceeds of proceeds. If the secured creditor loses its right in the proceeds once they take another form, the secured creditor would be subject to the same credit risks as would be the case if there were no rights in proceeds.

203. A further feature of movable property is that it is susceptible to numerous legal and physical transformations over time. For example, if tangible movable property is an animal, various modifications are possible. Female animals give birth to offspring and produce milk. Other animals may be shorn for their wool. Still other prize animals may produce marketable products. Bees may produce honey and silk worms may produce silk. In all these situations, encumbered assets may generate other property for the grantor even without a disposition of these assets. In many legal systems, this type of property is referred to as “natural fruits”.

204. Transformation also occurs in relation to intangible property. For example, a right to receive payment may carry interest; a lease of tangible property results in rental payments. These are often known as “civil fruits” or “revenues”. In addition, if the tangible property is an object, it may be manufactured or transformed. Wood may become a chair. Steel may become part of an automobile. Here, the initially encumbered asset is not disposed of, but the process of manufacture turns it into another, more valuable, object. Property that results from such transformation is often called “products”.

205. In other words, in the terminology of property law, these diverse new types of movable property are characterized as being “fruits, revenues, the natural increase

of animals, or products”. For the purposes of secured transactions law, however, the specific label is often not that important. What matters is the policy decision that States take concerning the effect of the security right in the fruits, revenues and products. That is, in each of these cases, States must decide whether a security right that is taken on the animal, steel, right to payment or the object subject to lease, may extend to any of the property “produced” by that original property.

206. In some legal systems, civil or natural fruits are clearly distinguished from proceeds arising from disposition of encumbered assets and are made subject to different rules. The difficulty in identifying proceeds of disposition and the need to protect rights of third parties in proceeds is often cited to justify this approach. Other legal systems do not distinguish between civil or natural fruits and proceeds of disposition and subject both to the same rules. The difficulty in distinguishing between civil or natural fruits and proceeds, the fact that both civil or natural fruits and proceeds flow from, take the place of or may affect the value of the encumbered assets are among the reasons mentioned to justify this approach. Moreover, parties typically provide in their security agreement that the security taken on the initial property extends into all these other forms of property. For this reason, some States consider all these transformations to constitute “proceeds” of the originally encumbered asset. Because this is the normal contractual practice in secured transactions regimes today, in this Guide all the above transformations are considered as “proceeds” arising from the initially encumbered assets (for the definition of “proceeds”, see para. 19 above).

(b) Scope of a security right in proceeds

207. A legal system governing security rights must address two distinct questions with respect to proceeds. The first issue is whether the secured creditor retains the security right if the encumbered asset is transferred from the grantor to another person in the transaction that generates the proceeds. Strictly speaking, this is not a proceeds question. Rather, it relates to the issue of whether a security right comprises what might be called a “right to follow” (for a discussion of this issue, see A/CN.9/631, recommendation 85; and chapter VII on priority of a security right as against the rights of competing claimants; A/CN.9/631/Add.4, para. 57).

208. The second issue concerns the secured creditor’s rights with respect to the proceeds. The justification for a security right in proceeds lies in the fact that, if the secured creditor does not obtain such a right, its rights in the encumbered assets could be defeated or reduced by a disposition of those assets and its expectation to receive any income generated by the assets would be frustrated. If the legal system did not permit the creation of a security right in proceeds upon disposition of encumbered assets, it would not adequately protect the secured creditor against default and thus the value of the encumbered assets as a source of credit would diminish. This result, which would have a negative impact on the availability and the cost of credit, would be the same even if the security right in the original encumbered assets were to survive their disposition to a third party. The reason for this result lies in the possibility that a transfer of the encumbered assets may increase the difficulty in locating the assets and obtaining possession thereof, increase the cost of enforcement and reduce the value of the assets.

209. A right in proceeds typically arises where the encumbered assets are disposed of because the proceeds replace the original encumbered assets as assets of the grantor. In systems that treat civil or natural fruits as proceeds, a right in such proceeds may arise even if no transaction takes place with respect to the

encumbered assets (e.g. dividends arising from stocks) because this is consistent with the expectations of the parties.

210. If the secured creditor's right in proceeds is a proprietary right, the secured creditor will not suffer a loss by reason of a transaction or other event, since a proprietary right produces effects against third parties. On the other hand, granting the secured creditor a proprietary right in proceeds might result in frustrating legitimate expectations of parties that obtained security rights in those proceeds as original encumbered assets. However, in legal systems in which creation is distinguished from third-party effectiveness and priority, this result would occur only if the creditor with a proprietary right in proceeds had priority over the creditors with a right in proceeds as originally encumbered assets and such priority is determined on the basis of time of registering of a notice about the transaction in a public register. Thus, in those systems, potential financiers are forewarned about the potential existence of a security right in assets of their potential borrower (including proceeds of such assets) and can take the necessary steps to identify and trace proceeds and to obtain inter-creditor subordination agreements where appropriate.

211. Slightly different considerations apply where the proceeds in question are not proceeds of disposition, but are fruits, revenues and the increase of animals or the products of manufacture. In the last case, it would be the normal expectation of the parties that raw materials would be manufactured. The policy question is, consequently, whether a State should adopt a rule that requires a security agreement to provide explicitly that the security is taken not only in the raw materials but also in any product that is manufactured from those raw materials, or whether the assumption should be that the manufactured products are automatically covered by the security right and, if the parties do not wish this to be the case, they should so state in the security agreement. Most States do not require parties to specify that the security right passes into property manufactured from raw materials, as long as it can be clearly identified as having resulted from those raw materials.

212. Similar considerations bear on the decision as to whether parties should specify that the security right extends to offspring of animals, or whether they are automatically covered. As the normal expectation of the parties is that newborns would be covered, most States provide that a security right in the mother also automatically covers offspring. As for natural fruits (for example, wool, milk, eggs not hatched and honey), States take different positions. Many States require parties to specify in the security agreement that these natural fruits will be covered by the agreement. Other States provide that natural fruits are automatically covered unless the parties provide otherwise. In keeping with the general orientation of this Guide to provide recommendations that would be consistent with the normal practice of parties to a security agreement, the approach adopted is to consider these natural fruits to be automatically covered by the security agreement in the animal that produces the fruits.

213. Finally, as concerns civil fruits or revenues, reasons of economic efficiency normally would suggest that a security right in the capital payment (e.g. a negotiable instrument or receivable) should also embrace a right to the interest payable. This is because payments on such instruments or receivables are often blended payments of capital and interest. Only where it is easy to separate the repayment of the capital from the interest charges, and where the parties agree that the security right in the capital sum will not extend to the separate interest

generated, should the law permit the interest to be several from the initial obligation.

(c) Creating a security right in proceeds

214. The discussion above shows that there are practical reasons why many legal systems extend security rights in encumbered assets to various forms of proceeds (including proceeds of proceeds) through default rules applicable in the absence of an agreement to the contrary. In other legal systems, where an automatic right in proceeds does not exist, whether in respect of proceeds of disposition or in relation to one or more categories of fruits, increase of animals, revenues or products, parties are typically permitted to specify that they will take security rights in all types of asset as originally encumbered assets. In such systems, parties may be free to provide, for example, that a security right is created in substantially all of the grantor's assets (cash, inventory, receivables, negotiable instruments, securities and intellectual property). In such a way, the proceeds themselves become originally encumbered assets and are covered by the security right of the creditor even without a legal rule automatically providing a right in proceeds. In some of those legal systems, parties may also extend by agreement certain title-based security rights (e.g. retention of title) to proceeds.

215. Regardless of whether a right in proceeds flows automatically from a right in the originally encumbered assets, or whether it must be explicitly mentioned in the security agreement, there are no additional formalities imposed on parties that seek to claim a right in any of these forms of proceeds. The only requirement is that, in the former case, the security agreement should specify a right in the proceeds and indicate the kinds of proceeds that are meant to be included in the same security right, while in the latter case, it is sufficient to identify clearly the assets that are subject to the initial security right. In line with its general objective of facilitating secured credit, this Guide recommends approaches that will reflect the normal expectations of grantors and secured creditors that a security right in encumbered assets automatically extends to its identifiable proceeds without the need for parties to so provide in their security agreement (see A/CN.9/631, recommendation 18).

8. Commingled proceeds

216. When the assets that constitute proceeds of encumbered assets are not kept separately from other assets of the grantor, the question arises as to whether the security right in the proceeds is preserved. The answer to this question usually depends on whether the assets constituting proceeds are identifiable. Proceeds in the form of tangible property kept with other assets of the grantor can be identified as proceeds in any manner that is sufficient to establish that the items of tangible property are proceeds. In this respect, many States provide that the same principle that governs the preservation of the secured creditor's right in originally encumbered assets that has been commingled should also apply to tangible property that constitutes commingled proceeds. So, for example, if a grantor receives a certain amount of petrol as a swap for crude oil that has been sold and the petrol is commingled in a tank, the security right should continue into a proportion of the petrol in the tank as long as the secured creditor can prove that that amount of petrol was received as proceeds, and no additional steps are required in order to create (or preserve) the security right in these commingled tangible proceeds.

217. If, by contrast, the property constituting proceeds is intangible, such as receivables or rights to payment of funds credited to a bank account, and is not maintained separately from the grantor's other assets of the same type, such intangible property may be identified as proceeds as long as it can be traced to the originally encumbered assets. For example, as long as the secured creditor can prove that a certain amount of cash has been deposited as proceeds of the disposition of encumbered assets, then a proceeds claim could arise. The difficulty is that money is constantly entering and exiting from bank accounts and it is difficult to know what percentage of the money actually originated as proceeds.

218. Many States have quite complicated rules developed within banking practice to determine when funds deposited in a bank account can be traced. Examples of different tracing rules include (a) "first-in, first-out" ("FIFO"), which assumes that the first property to become part of a commingled mass is the first property withdrawn from the mass; (b) "last-in, first-out" ("LIFO"), which assumes that the last property to become part of a commingled mass is the first property withdrawn from the mass; and (c) the "lowest intermediate balance rule" ("LIBR"), which assumes, to the extent possible, that withdrawals from the commingled mass are not proceeds of the encumbered assets. Many States protect the security right by providing that the identifiable proceeds will consist of all funds deposited as proceeds, as long as the balance of the account is greater than the amount deposited as proceeds. Where the total amount is less than the total amount of proceeds deposited to the account, the identifiable proceeds are determined by taking the lowest intermediate balance and adding to it any further money in the form of proceeds added to the fund since that lowest balance was recorded. As with the case of commingled tangible proceeds, as long as the source of the intangible proceeds can be traced, no further steps need be taken by the parties in order to create (or preserve) the security right in these commingled intangible proceeds (see A/CN.9/631, recommendations 19 and 20; for priority in proceeds, see chapter VII, A/CN.9/631/Add.4, paras. 48-51).

9. Commingled tangible property

219. Historically, secured transactions regimes did not face the problem of maintaining identification of encumbered assets. Because security rights could be taken only in individually identified assets, it was rare that commingling of fungible property could arise. Today, however, many States permit parties to create a security right in a general category of (usually fungible) property. For example, the security could be taken in assets described as "all my present inventory of personal computers"; alternatively, a seller could take security in all the personal computers that it sells to a purchaser. In both these cases, it may be that assets subject to the security right are commingled in a manner that prevents separate identification with other assets of the same type that are not subject to the security right.

220. Two approaches are possible. Some States provide that, once the property is commingled, it is no longer identifiable and the creditor's security right is lost. This approach places the burden on the secured creditor to ensure that the grantor keeps the encumbered assets separated from other assets of a similar nature to prevent commingling. Other States provide that the security right survives and may be claimed in the commingled assets in the same proportion as the encumbered asset bore to the total amount of the commingled assets. Under this approach, if \$100,000 worth of oil is commingled with \$50,000 worth of oil in the same tank, the secured

creditor is deemed to have security over two-thirds of whatever oil remains in the tank at the moment it becomes necessary to enforce the security.

221. As this Guide adopts the general principle that security rights should be protected as much as possible, it recommends that the second approach (i.e. preservation of the security right in the commingled property in the same proportion as the encumbered assets and the assets not encumbered by the security contributed to the mass) be adopted. In other words, once a security right is created in the encumbered assets, no further steps are necessary to preserve that security right should the encumbered asset ultimately be commingled with similar assets of the same type that are not subject to the security right (see A/CN.9/631, recommendation 21).

10. Tangible property commingled in a mass or product

222. When tangible property is so mixed with other tangible property that its separate identity is lost in a product or mass, it is necessary to determine the conditions under which a security right in the original asset may be claimed in the product that has been produced. For example, it may be that a security right is taken in flour that is destined to become bread through manufacturing or production. Two basic approaches are taken in various legal systems. In some States, once the flour loses its identity as flour, the security right is extinguished. If the parties wish the security right to pass into the bread, it is necessary to provide that the original security encumbers both flour and any product into which the flour may be transformed or manufactured. Other States take the position that the security right automatically passes into the manufactured product as long as it can be established that the product resulted from the raw materials subject to the security right. As it is the normal expectation of the parties that the raw materials will be manufactured, this Guide takes the position that it should not be necessary to provide in the security agreement that the security right passes into the manufactured product. The resulting product is in some sense the replacement or substitute for the security right in the no longer existing raw materials (see A/CN.9/631, recommendation 21).

11. Creation of a security right in an attachment

223. Movable property may be attached to movable or immovable property in such a way that its identity is not lost and it becomes an attachment (for the definitions of “attachment to movable property” and “attachment to immovable property”, see para. 19 above). In these cases, the question arises as to whether a security right, to which the original movable was subject before attachment, is preserved.

224. In some States, it is not possible to create a security right in an attachment that has already become attached to other property (whether movable or immovable). In order to be effective against the attachment, the security right has to be created prior to attachment. However, in these States, a security right in an item of movable property may continue if it becomes an attachment to immovable or movable property regardless of the cost or difficulty of removing the attachment from the property to which it was attached and regardless of whether the attachment has become an integral part of that property (see A/CN.9/631, recommendation 22). In other States, it is also possible to create a security right in an item of movable property that is already an attachment, whether the attachment is to immovable property or to other movable property. For these States, the cost or difficulty of detachment is also irrelevant to determining if the security right may be created.

In some States, a security right may be created in an item of movable property that is an attachment to immovable property. In both cases, whether the attachment may be readily removed without damage from the property to which it is attached is relevant for determining the priority among competing claimants (see A/CN.9/631, recommendations 93-95), but is not relevant to the question of whether the security right may be created.

225. The key issue is to determine whether any additional steps must be taken to create a security right in an item of property that is an attachment beyond those necessary to create an ordinary security right. Except in those States that do not distinguish between creation, third-party effectiveness and priority, no additional steps are required since this is an issue of creation, not priority.

12. Creation of a security right in a mass or product

226. As noted, an item of tangible property may be commingled with one or more other items of tangible property in such a way that its identity is lost. In this case, the question arises as to whether a security right to which the original item of tangible property was subject before commingling, is preserved. The general position of most States is that the security right is preserved following commingling, assuming that the source of at least some of the commingled property can be identified as being initially encumbered property (see A/CN.9/631, recommendation 23). The security right in the originally separate property is converted into a security right in the product or mass (as to priority of competing claims in commingled goods, see A/CN.9/631, recommendations 96-98).

227. However, and in contrast to the general approach taken to the creation of security rights in attachments, in most States a security right may not be created in items of tangible property after they have been commingled. That is, while an attachment can always be seen to have at least a notional separate identity, where oil is commingled in a tank, or flour is manufactured into bread, the separate identity of the initially encumbered asset disappears. For this reason, it is generally not possible to create a separate security right in items of property that have already been commingled. That is the approach adopted in this Guide (see A/CN.9/631, recommendation 23).

B. Asset-specific recommendations

1. Effectiveness of a bulk assignment of receivables and an assignment of future, parts of and undivided interests in receivables

228. With respect to the assignment of receivables, which is widely used in important financing transactions, a trend is developing whereby the assignment is subjected to the same provisions whether it involves an outright transfer, an outright transfer for security purposes or a security transfer. This trend is mainly justified by the fact that it would be very difficult for third parties to determine the nature of an assignment, as well as by the need to have the same priority rules govern all types of assignment. This trend is reflected in the United Nations Assignment Convention (see art. 2). However, legal systems differ as to the requirements for an effective assignment. Some legal systems require a writing or notification of the debtor of the receivable. Other legal systems require a writing for the assignment to be effective as between the assignor and the assignee and registration for it to be effective as against third parties. Legal systems also differ with respect to the effectiveness of

assignments of future receivables and receivables not specifically identified, as well as with respect to the effectiveness of assignments made despite anti-assignment clauses in the contracts from which the assigned receivables arise. The United Nations Assignment Convention validates all these assignments (see art. 8 of the Convention, reflected in A/CN.9/631, recommendation 24).

2. Effectiveness of an assignment of receivables made despite an anti-assignment clause

229. In some States, effect is given to contractual restrictions on dispositions in order to protect the interest of the party in whose favour the restriction is agreed upon (i.e. the assignor or the debtor of the receivable). In other States, no effect or only a limited effect is given to contractual restrictions on dispositions so as to preserve the grantor's freedom of disposition, in particular if the person acquiring a right in an asset is not aware of the contractual restriction.

230. The United Nations Assignment Convention takes a similar approach to support transferability of receivables, which is in the interest of the economy as a whole. If the assignor is able to obtain credit on the basis of its receivables, it is likely to extend credit to the debtor of the receivable; effectiveness of the assignment is also in the interest of an assignee that provides credit to the assignor. Debtors that require protection, such as a consumer or a State, may protect themselves through statutory prohibitions.

231. Under article 9, paragraph 1, of the United Nations Assignment Convention, an assignment is effective despite a contractual restriction on assignment agreed upon between the assignor ("grantor" in the terminology of the Guide) and the debtor ("debtor of the receivable" in the terminology of the Guide). However, the effect of this provision is limited in two ways. First, its application is limited to broadly defined trade receivables (see art. 9, para. 3, of the Convention); and second, if such a contractual restriction is valid under law applicable outside the Convention, article 9 does not invalidate it as between the assignor and the debtor of the receivable (see art. 9, para. 2). The grantor is free to claim damages from the assignor for breach of contract, if such a claim exists under law applicable outside the Convention, but may not raise this claim against the assignee by way of set-off (see art. 18, para. 3). In addition, mere knowledge of the existence of the restriction on the part of the assignee ("secured creditor" in the terminology of the Guide) is not enough for the avoidance of the contract from which the assigned receivable arises (see art. 9, para. 2).

232. This approach promotes receivables financing transactions since it relieves the assignee (i.e. the secured creditor) of the burden of having to examine the contracts from which the assigned receivables arose in order to ascertain whether transfer of the receivables has been prohibited or made subject to conditions. Otherwise, lenders would have to examine a potentially large number of contracts, which may be costly or even impossible (e.g. in the case of future receivables, see A/CN.9/631, recommendation 25).

3. Creation of a security right in a personal or property right securing a receivable, a negotiable instrument or any other intangible asset

233. If a grantor creates a security right in a receivable, negotiable instrument or any other intangible asset in favour of a secured creditor, the issue arises as to whether the secured creditor also has, automatically and without any further action

by the grantor or the secured creditor, the benefit of any personal right (e.g. a guarantee) or property right (e.g. a security right in other movable property or a mortgage on immovable property) that secures payment of the receivable, negotiable instrument or other payment claim.

234. A strong case can be made that the creation of the security right in the receivable, negotiable instrument or other intangible asset should also automatically give the secured creditor the full benefit of the grantor's full set of rights with respect to that receivable, negotiable instrument or intangible asset. Thus, if the obligation to pay the receivable, negotiable instrument or other intangible asset is itself secured by a security right in an asset of the obligor, the secured creditor should also receive the benefit of the grantor's rights with respect to the security right in the obligor's asset (see A/CN.9/631, recommendation 26, subpara. (a)).

235. The recommendation described in the preceding paragraph should apply regardless of whether the grantor is limited by any agreement with the debtor of the receivable or the obligor on the negotiable instrument or other intangible asset from creating a security right in (a) the receivable, negotiable instrument or other intangible asset; or (b) the personal or property right securing payment of performance of the receivable, negotiable instrument or other intangible asset (see A/CN.9/631, recommendation 26, subpara. (d)). However, nothing contained in such recommendation should affect the grantor's liability for breaching that agreement, except that the other party to the agreement may not avoid the agreement giving rise to the receivable, negotiable instrument or other intangible asset, or the property right securing the same, upon the sole ground of that breach (see A/CN.9/631, recommendation 26, subpara. (e)).

236. However, because the secured creditor's rights with respect to the personal or property right flows from the grantor's rights, the secured creditor's rights with respect to that personal or property right cannot be greater than the grantor's rights with respect to it.

237. Where the receivable, negotiable instrument or other intangible asset is secured by an independent undertaking, the secured creditor's security right does not extend to the right to draw under the independent undertaking, but rather extends only to the proceeds under an independent undertaking (see A/CN.9/631, recommendation 26, subpara. (b)). This is consistent with the theme of the Guide that a beneficiary of an independent undertaking may not transfer the right to draw without the consent of the guarantor/issuer, confirmer or other nominated person.

238. There are several practical reasons supporting the recommendation that the secured creditor should have a security right in the proceeds under an independent undertaking. First, this result merely eliminates the need for the secured creditor to take certain additional steps in its loan documentation with the grantor. That is because, even if the Guide were to make the distinction between an accessory right and an independent right, since that distinction is made under the laws of a number of States, that distinction would not prevent the secured creditor from obtaining a security right in proceeds under an independent undertaking. It would merely require the secured creditor to take the formalistic steps of including an express creation of a security right in the proceeds under an independent undertaking in its security agreement with the grantor. Eliminating the need for such formalism furthers the Guide's goal of reducing the costs of credit and making more credit available by reducing transaction costs.

239. Second, the automatic creation rule for a security right in proceeds under an independent undertaking would make sense in practice as being consistent with the parties' normal expectations. A secured creditor looking to the grantor's receivables as encumbered assets would normally expect that, regardless of how the receivables owed were paid (e.g. whether directly by the debtors of the receivables or by a draw under an independent undertaking securing one or more of the receivables, the secured creditor would have a security right in the payment as proceeds of the receivables. Indeed, in some cases a secured creditor may be willing to extend credit to a given borrower at a lower rate if the secured creditor knows that its security right in the receivables owed to its borrower includes a security right in the right to proceeds under an independent undertaking in so far as those receivables are secured by the independent undertaking. A rule that is consistent with the parties' normal expectations will avoid unfair surprise and create greater certainty in States that enact the recommendations of the Guide. Greater certainty will make credit providers more confident in extending credit and accordingly will further the goal of the Guide to encourage the greater availability of secured credit.

240. Third, the recommendation does not affect in any way the rights of the guarantor/issuer, confirmer or any nominated person under the independent undertaking. Neither the guarantor/issuer, nor any confirmer nor any nominated person has any obligation to accept a drawing from anyone other than the beneficiary of the independent undertaking, or has any obligation to pay anyone other than the beneficiary, without the consent of the guarantor/issuer, confirmer or nominated person.

241. The Guide qualifies the foregoing recommendation in a number of important respects. First, it does not affect a right in immovable property that, under law other than the secured transactions law, is transferable separately from the receivable, negotiable instrument or other intangible asset that it secures. This recommendation addresses the device that may exist in some States which permits an owner of immovable property to create a right (mortgage) in the immovable property even though at the time of creation the right does not secure any obligation. The owner may then transfer that right to a creditor that may in turn transfer the right to another creditor. Like an independent undertaking, the right in the immovable property appears to be a right in itself independent of any obligation.

242. The second qualification is that, consistent with the United Nations Assignment Convention, the recommendation applies only to certain types of receivable, negotiable instrument or other intangible asset (see A/CN.9/631, recommendation 26, subpara. (f), such as "trade receivables" (e.g. receivables evidencing the sale of goods and services).

243. The third qualification is that the recommendation does not affect any obligations of the grantor to the debtor of the receivables or the obligor on the negotiable instrument or other intangible asset (see A/CN.9/631, recommendation 26, subpara. (g)).

244. Finally, the recommendation would not affect any requirement under law other than the secured transactions law relating to the form or registration of the creation of a security right on any asset that secures payment or performance of a receivable, negotiable instrument or other intangible asset, but only to the extent that the automatic creation of the benefit of such security right is not impaired (see A/CN.9/631, recommendation 26, subpara. (h)).

4. Creation of a security right in proceeds under an independent undertaking

245. It is well established under the law and practice governing independent undertakings in many States that the right to draw under an independent undertaking may not be transferred without the consent of the guarantor/issuer, confirmer or nominated person under the independent undertaking. The Guide recognizes and respects this principle.

246. However, the Guide also draws a distinction between the right to draw under an independent undertaking and the right to receive the proceeds of a draw under an independent undertaking. Furthermore, the Guide takes the position that nothing in the law or practice governing independent undertakings prevents the beneficiary of an independent undertaking from creating a security right in the proceeds of the undertaking (i.e. the right to receive the proceeds once payment is made), even if the right to draw under the undertaking is itself not transferable under applicable law and practice (see A/CN.9/631, recommendation 28).

5. Creation of a security right in a negotiable document or goods covered by a negotiable document

247. When a negotiable document has been issued with respect to goods and is outstanding, the document embodies the title to the goods. As a result, it is appropriate that the creation of a security right in the negotiable document also operates as the creation of a security right in the goods themselves, provided that the security right in the document is created while the issuer is in possession of the goods (see A/CN.9/631, recommendation 29). For this purpose, possession may be direct (e.g. by the issuer of the document) or indirect (e.g. by an agent on behalf of the issuer of the document; for the definition of “possession”, see para. 19 above).

C. Recommendations

[Note to the Commission: The Commission may wish to note that, as document A/CN.9/631 includes a consolidated set of the recommendations of the draft legislative guide on secured transactions, the recommendations are not reproduced here. Once the recommendations are finalized, they will be reproduced at the end of each chapter.]

A/CN.9/631/Add.2 [Original: English]**Note by the Secretariat on recommendations of the UNCITRAL draft
Legislative Guide on Secured Transactions, submitted to the
Working Group on Security Interests at its twelfth session****ADDENDUM****CONTENTS**

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V. Effectiveness of a security right against third parties

A. General remarks

1. Introduction

(a) Purpose of third-party effectiveness requirements

1. In some States, a security right in movable property takes effect both between the parties and against third parties as soon as the security agreement is concluded without the need for any further act. This approach has the advantage of simplicity.

However, it does not provide a potential secured creditor with a reliable means of verifying whether assets in the grantor's possession are already encumbered. In addition, if the grantor sells or transfers possession of an encumbered asset, without the authorization of the secured creditor, to a buyer (and sometimes a pledgee) that purchases (or takes possession of) an asset without knowledge that it is already subject to a security right, a secured creditor may find its security right defeated. This result is likely to have a negative impact on the availability and the cost of credit.

2. Many States, therefore, require an additional step to be taken for the security right to become fully effective. This additional step is designed to provide some form of public notice of the actual (and in some cases merely the potential) existence of a security right in the grantor's assets. Examples of such acts include the transfer of possession of the encumbered assets to the secured creditor and the registration of a notice in a public registry. These types of acts contribute to the efficiency and effectiveness of a regime of secured lending in several ways. First, they enable a secured creditor to determine in advance of taking a security right whether the grantor's assets are already encumbered. Second, as they alert the grantor's creditors and other third parties to the existence of the security right, there is no need for special rules protecting third parties against the prejudice of "secret" security rights. Third, they provide a defined temporal event for the ordering of priority between a secured creditor and a competing claimant (for the definitions of "competing claimant" and "secured creditor", see A/CN.9/631/Add.1, para. 19).

(b) Distinction between creation and third-party effectiveness

3. Among States that require such an additional act, some treat it as a prerequisite to the effectiveness of the security right even as between the parties. The idea here is that, as a central goal of taking security is to obtain rights enforceable against the grantor and third parties, there is no utility in distinguishing between effectiveness between the parties and third-party effectiveness. In other States, the additional step is required only for the purposes of making the security right effective against third parties. This approach is based on the idea that, as the requirement for taking an additional step is aimed primarily at ordering the priority of rights between a secured creditor and a competing claimant, there is no reason why it should be a pre-condition to the right of the secured creditor to enforce its rights under the security agreement and secured transactions law as against the grantor (for the definition "security agreement", see A/CN.9/631/Add.1, para. 19).

4. Many States that have recently modernized their secured transactions law adopt the second approach. In States that do not recognize a distinction between *inter partes* and *erga omnes* effects of property rights generally, adoption of this approach may generate some conceptual concerns. For example, most States do not admit that a pledge may be created only between the parties. Nonetheless, the approach of the Guide is not entirely novel even in these States. It merely carries the idea of consensualism, which is now accepted as part of the law of sale in most States, into the realm of security rights. Moreover, concerns about recasting "property" agreements like pledge, do not apply if the additional step is registration, since in such cases the grantor always remains in possession of the encumbered asset. Finally, not drawing the distinction between *inter partes* and *erga omnes* effects adds an additional formality to the creation of a security rights without any

compensating advantage to grantors or secured creditors (see A/CN.9/631/Add.1, paras. 143-147).

5. In order to promote efficient secured credit, this Guide recommends adoption of the approach that distinguishes between steps required for creation (effectiveness between the parties) of a security right and those necessary to achieve third-party effectiveness. Once the conditions for creation of a security right addressed in chapter IV (see A/CN.9/631/Add.1) are satisfied, the security right becomes effective between the grantor and the secured creditor (see A/CN.9/631, recommendation 31). However, in order for the security right to affect third parties, the requirements for third-party effectiveness addressed in this chapter must also be satisfied (see A/CN.9/631, recommendation 30).

(c) Meaning of “third parties”

6. While it is normally not difficult to determine who are the parties to a security agreement (i.e. the grantor and the secured creditor) defining who is to be considered a “third party” is more complex. Indeed, States take quite different approaches to the categories of third parties against which a security right is ineffective unless the required additional step is taken. In some States, a security right has no effect against third parties, whatever their status, until the additional step is taken. Other States adopt a second, more qualified, approach. A security right is presumptively effective against third parties upon creation but can be defeated by specified categories of competing claimants if the additional step required for full-fledged effectiveness is not taken before their rights arise (see A/CN.9/631/Add.1, paras. 143-147).

7. In States that adopt the more qualified approach, the additional step is required only for effectiveness against secured creditors and transferees of the encumbered assets. As against the grantor’s unsecured creditors and the insolvency representative, the security right is fully effective upon its creation. The distinction between these categories of “third parties” is based on the idea that notice of a security right should matter only to creditors that are presumed to be those that have taken a security right or purchased or otherwise given value in reliance on the grantor’s unencumbered title. For example, unsecured creditors are presumed not to rely on the presence or absence of security rights in the grantor’s assets, since the very act of extending credit on an unsecured basis implies an informed acceptance of the risk of subordination to secured creditors that may later acquire security rights in the grantor’s assets.

8. There are, nonetheless, several reasons why this approach to rights of unsecured creditors, judgement creditors and insolvency representatives may not be well suited to an efficient secured transactions regime. First, while unsecured creditors base their decision to lend on the grantor’s general financial health, the presence or absence of security rights may be one of the factors upon which that assessment is based and may also be relied upon by credit reporting agencies on whose services unsecured creditors may rely. Second, the requirement for timely public registration or some equivalent additional step reduces the risk that an alleged security right is a collusive arrangement between an insolvent grantor and a preferred creditor to defeat the claims of other unsecured creditors. Third, it enables judgement creditors to determine in advance of initiating costly enforcement action whether the grantor’s assets are already encumbered. It also reduces the costs of insolvency proceedings

by giving the insolvency representative an efficient means of ascertaining which assets of the insolvent grantor are potentially encumbered. Finally, the risk of finding its security right defeated by intervening judgement enforcement or insolvency proceedings provides a significant incentive to secured creditors to make their security rights fully effective in a timely fashion.

9. In some States that generally protect the rights of subsequent secured creditors or transferees against security rights that have not been made effective against them through the required additional step, an exception is made where these subsequent secured creditors or buyers acquire their rights with actual knowledge of the existence of a prior security right. Again, there are reasons why this qualification is not well suited to an efficient secured transactions regime. First, a key objective of an efficient regime is to provide *a priori* (i.e. in advance of the conclusion of the security agreement and extension of credit) certainty in the ordering the competing rights to encumbered assets. A priority rule that depends on fact-specific *ex post facto* litigation is inimical to that goal. Second, mere knowledge of the existence of a prior security agreement does not imply bad faith on the part of a subsequent secured creditor. If the prior secured creditor has not taken the steps necessary to make its security right fully effective against third parties, the subsequent creditor may reasonably assume that it has implicitly consented to the risk of subordination. Third, establishing knowledge on the part of another party and the exact extent of knowledge raises difficult questions of proof.

10. Some States also deny protection to a subsequent donee of an encumbered asset on the theory that, as between a secured creditor that by definition has given value for its security right and a donee that has not, the secured creditor should be protected. For reasons similar to those just canvassed in the preceding paragraph, this qualification is not well suited to efficiency in the secured lending regime. Determining the status of a transferee of an encumbered asset invites *ex post facto* litigation contrary to the goals of achieving *a priori* certainty and predictability. Moreover, even if the donee's status is not contested, the donee may well have changed its position in reliance on the unencumbered status of the asset (for example, by creating a security right in favour of another creditor).

11. The above-mentioned discussion of different approaches to determining whether certain categories of competing claimants should either be (i) subordinated to even security rights that have not been made effective against third parties, or (ii) have priority even over security rights that have been made effective against third parties at a later time illustrates that such distinctions are generally inimical to efficiency, transparency and predictability in the secured transactions regime. For this reason, this Guide recommends the first approach noted above (see A/CN.9/631, recommendation 30). Until the conditions for third-party effectiveness are satisfied, the security right is ineffective against intervening rights in the encumbered assets acquired by third parties regardless of the type of the competing claimant.

(d) Relationship between third-party effectiveness and priority

12. Attaining third-party effectiveness does not, of itself, determine questions of priority. It does produce though some priority consequences in the sense that a security right that has not been made effective against third parties cannot be set up as against the rights of a competing claimant in the same encumbered assets. However, as between competing claimants, all of whom have achieved third-party

effectiveness of their rights, additional rules are required. As explained more fully in chapter VII (see A/CN.9/631/Add.4, paras. ...), priority depends upon the nature and status of the rights with which the security right is in competition. For example, if more than one security right have been made effective against third-parties, it will be necessary to rank the competing security rights as between themselves.

13. Moreover, the concept of priority is not identical in every State. Some States take the position that priority speaks only to the rights of competing secured and unsecured creditors in the assets of the grantor. The rights of other competing claimants such as transferees and lessees are determined by reference to rules governing the character of the transferor's title. Other States have a broader, functional, concept of priority. Every conflict between competing claimants is a priority dispute. This approach to priority is common whenever the secured transactions regime considers that, in relation to third-party effectiveness, no distinction should be drawn between different categories of claimant.

14. As this Guide adopts the latter concept of third-party effectiveness, it also adopts the broader concept of priority. In other words, even though third-party effectiveness and priority are distinct concepts, because the various priority rules set out in chapter VII conceive priority in relative terms, it is essential to take these priority rules into account in assessing the degree of protection afforded by third-party effectiveness or by particular methods of achieving third-party effectiveness. For example, this chapter recognizes that, once the requirements for third-party effectiveness have been satisfied, a security right continues in the asset even in the hands of a subsequent transferee (see A/CN.9/631, recommendation 32). However, the secured creditor's right to follow the assets (its *droit de suite*) is not absolute. Under the priority rules addressed in chapter VII, a buyer of an encumbered tangible asset and a holder of negotiable documents and instruments transferred in the ordinary course of the grantor's business generally take free of a security right even when it is effective against third parties (see A/CN.9/631, recommendations 85-87).

(e) Overview of methods for achieving third-party effectiveness

15. Historically, States devoted little attention to developing and reconciling different methods for achieving third-party effectiveness. This lack of attention can be traced to either a general prohibition on non-possessory security rights over movable property (movable property is not susceptible to hypothecation) or to the general unenforceability against third parties of non-possessory security rights in movable property. In these States, the pledge was the only available security device, and grantor dispossession served both to constitute the pledge, as well as provide the publicity function necessary for third-party effectiveness. As economies developed, however, the limits of the pledge became more obvious. A commercial grantor would normally wish to remain in possession of its business assets, so some alternative to possession had to be developed. Hence, States came to develop the concept of registration of rights as an additional means for achieving third-party effectiveness.

16. In many States, registration is the principal method for achieving third-party effectiveness. While there are different types of registration regimes in different States, a frequent approach is to establish a general security rights registry (see A/CN.9/631, recommendation 33). In addition to registration, alternative methods are also available, depending on the nature of the encumbered assets (see

A/CN.9/631, recommendation 35). For example, almost all States provide for the continuance of the “pledge” idea in the sense that a security right in tangible property may be made effective against third parties by a transfer of possession of the pledged asset to the secured creditor.

17. While registration in a general security rights registry and transfer of possession to the secured creditor are the most common methods for achieving third-party effectiveness, they are typically not exclusive. Specialized “control” rules are often enacted to apply to a security right in a right to payment of funds credited to a bank account and in a right to proceeds under an independent undertaking (for the definition of these terms, see A/CN.9/631/Add.1, para. 19). Furthermore, in most States a security right in an attachment to immovable property can be made effective against third parties by registration in the immovable property registry. Finally, under other law in many States, a security right in a specific type of movable property can be registered in a title registry (for example, a ship’s registry) or noted on a title certificate.

18. In some States, it is also possible to achieve third-party effectiveness of a security right in a receivable by notifying the debtor of the receivable. In practice, a secured creditor generally will not demand direct payment of receivable until there is a default on the part of the grantor. Indeed, even when receivables are assigned outright, the assignee will frequently wish to leave collection in the hands of the assignor. In light of these practicalities, the Guide treats a demand for payment simply as a collection or enforcement technique and not a method for achieving third-party effectiveness. In addition, registration offers a more efficient means for secured creditors and assignees to evaluate priority risk at the outset of the transaction particularly where the security right or assignment covers all of the grantor’s present and after-acquired receivables. Otherwise, they would be subject to the risk of a loss of priority based on the arbitrary timing of when a competing secured creditor or assignee happened to give notice to the debtor on the receivable.

19. Notwithstanding the principle that an additional step is required in order to achieve third-party effectiveness of a security right, some States provide that in a number of exceptional instances, a security right is automatically effective against third parties without the need for the secured creditor to register or take possession or perform any other positive step. However, as a general rule in most States, the security right becomes effective against third parties only if it is made effective against third parties by one or another of the alternative methods just outlined.

20. In most States, these alternative methods are not exclusive. For example, most States provide that where a security right may be made effective against third parties by transfer of possession to the secured creditor, it may also be made effective by registration. Moreover, even where assets are encumbered by the same security agreement, most States provide that different methods may be used for different assets (see A/CN.9/631, recommendation 37). The one exception to the principle of non-exclusivity flows from the particular character letter of credit transactions (the Guide uses the term “independent undertaking; for the definition, see A/CN.9/631/Add.1, para. 19). Invariably States provide that a security right created in proceeds under an independent undertaking can only be made effective against third-parties by the secured creditor taking control with respect to the proceeds (see A/CN.9/631, recommendation 36).

21. This said, in many States registration may, in practice, be an exclusive method in the sense that no other method is available to achieve third-party effectiveness for the particular type of encumbered asset in question. This is generally true, for example, for security rights in receivables and inventory.

(f) Outline of chapter

22. Sections A.2 through A.4 of this chapter discuss in detail the three most common methods for achieving third-party effectiveness (i.e. registration in a general security rights registry, possession and registration in a specialized registry). Sections A.5 through A.7 consider cases where a security right that has been made effective against third parties continues to be effective in assets not initially subjected to the security right. Sections A.8 and A.9 address other issues of continuity, for example where the asset or the grantor changes location, or where third-party effectiveness may have lapsed.

23. Part B is devoted to a discussion of particular methods for achieving third-party effectiveness that apply to specific types of asset. Section B.1 considers the important cases of security right in a personal or property right securing the payment of a receivable, negotiable instrument or any other intangible asset. Section B.2 reviews third-party effectiveness of security over the right to payment of funds credited to a bank account. Section B.3 assesses how third-party effectiveness may be achieved where the security encumbers the right to proceeds under an independent undertaking. Finally, section B.4 addresses third-party effectiveness of a security right in a negotiable document or in property covered by a negotiable document.

24. Part C sets out a series of recommendations about methods for achieving third-party effectiveness and the consequences of doing so.

2. Registration in a general security rights registry

(a) General

25. While public registration is a widely accepted method of achieving third-party effectiveness, registry systems differ widely. In many States, registration requirements have evolved incrementally over a long period of time, resulting in a patchwork of uncoordinated systems within the same State organized according to diverse criteria. For example, some of these systems may be organized by reference to the type of transaction (for example, retention-of-title and hire-purchase registries). Other systems may be organized by reference to the status of the grantor (for example, corporations or commercial enterprises), or by reference to the identity of the secured creditor (for example, banks). Still other systems may be organized by reference to the type of encumbered assets (for example, equipment or machinery or receivables registries).

26. States also take different approaches to the formalities that must be followed to register. Some require only a notice to be registered. Other States require that a full summary of the rights set out in the security agreement be registered. Still other States require that the full security documentation to be registered along with formal certificates or affidavits attesting to the identity of the participants and the authenticity of their signatures and legal capacity.

27. Beginning in the latter part of the twentieth century, an increasing number of States came to establish new registries or to significantly reorganize or replace their existing registry systems with respect to security rights in movable property. These reforms involved two distinct developments. In the first place, where existing systems were dispersed and fragmented, States replaced them with a central general registry covering all security rights in movable property, regardless of the identity of the parties, the nature of the encumbered assets or the form of the transaction giving rise to the security right. Likewise, States that established for the first time a registry for security rights in movable property invariably opted for a central general registry. Secondly, in most of these systems, States also substantially changed the mechanics of registration. The goal was to substitute the registration of a simple notice containing only minimal details about the security right to which it relates for the more cumbersome system of registering either the security documentation or a certified summary of it. That is, in these systems, the security agreement that creates the security right is not registered, nor is its existence or content verified by the system.

28. For many States, this second feature of modern registries constitutes a significant departure from the generally accepted concept of registration of security rights. Even in those States where full documentation is not registered, the idea is that the registry serves to inform searchers about an existing security right. The registration proves the right, and therefore can only be made once the right comes into existence. This explains why it is thought to be confusing, if not incoherent, to describe these modern registries as involving registration. As the secured creditor normally will simply register a notice about either its intention to take a security right (whether or not it has already acted on that intention), many States prefer to describe these registers not as registry systems, but as “notice filing” systems.

29. Regardless of the nomenclature used to describe these newer systems for achieving third-party effectiveness, it is apparent that they greatly simplify the process of providing a reliable source of information about potential security rights. When combined with advances in computer technology, a “notice-filing” system constitutes a highly efficient and cost-effective registration and searching process. For these reasons, this Guide recommends that States establish public registry systems that (i) are centralized, general and comprehensive of all security rights, and (ii) that require only the registration of a notice that sets out the basic details about the security right to which it does or may relate. It also endorses the idea that registration of a notice of a security right in such a registry should be established as a general method of achieving third-party effectiveness (see A/CN.9/631, recommendation 33). The design and operational details of different systems for establishing such a registry are addressed in chapter VI of this Guide (see A/CN.9/631/Add.3).

(b) Registration separate from creation of the security right

30. As noted in the preceding discussion, States have traditionally taken two different approaches to the relationship between registration and creation of a security right. In some States, the right itself is only created once registration has occurred. In other States, registration is required only as an additional step necessary to achieve third-party effectiveness. This Guide recommends adoption of the second approach (see A/CN.9/631, recommendation 30).

31. Several important consequences flow from the idea that registration of a simple notice containing only basic details about the security right concerns only third-party effectiveness. The security agreement to which the notice relates is not registered. Nor is its existence or content shown to or verified by the registry system. Creation of the security right (its effectiveness as between the parties) and registration are completely independent acts: registration does not create or evidence the creation of the security right; nor is registration necessary for creation of the security right (see A/CN.9/631, recommendation 34).

32. Whether a security right has actually come into existence cannot be determined from a search of the registry. Existence depends on establishing (by reviewing off-record evidence and documentation) that the parties have concluded a security agreement that satisfies certain formal and essential requirements, and that the grantor has rights in (or the power to encumber) the assets described in the security agreement (see A/CN.9/631, recommendations 12-14). Similarly, the scope of the encumbered assets depends primarily on the description set out in the security agreement, not in the registered notice (if the description in the security agreement covers a narrower range of assets than the description in the registered notice, the description in the security agreement is determinative). Only where the description of encumbered assets in the registered notice is narrower in scope than that in the security agreement, will the extent of third-party effectiveness be controlled by the description in the registered notice.

(c) Registration insufficient for third-party effectiveness

33. An important consequence of a “notice-filing” system of the type recommended in this Guide is that the registration is no guarantee of the actual existence of a security right. In other words, unlike traditional approaches to registration in many States, “notice” registration does not prove the existence of the security right. This means that registration by itself does not result in third-party effectiveness of the right described in the notice. That status is acquired only if and when the requirements for creation of a security right are also satisfied (see A/CN.9/631, recommendation 33).

34. There are two implications of this approach to registration, which increase the flexibility and efficiency of the secured transactions system. First, while creation is a prerequisite to third-party effectiveness, it need not precede registration. As explained in chapter VI (see A/CN.9/631/Add.3, paras. 73-75), a notice of a security right may be registered either before or after a security agreement is concluded. Second, while a security right covering after-acquired assets (i.e. acquired after the creation of the security right) comes into existence in respect of those assets only as they are acquired, it is possible to register of a notice describing them as potentially encumbered assets.

35. While it is often the case that no great consequences flow from differences in the order in which these two steps to achieve third-party effectiveness (i.e. creation of a security right and registration), this is not always true. The time of creation is important, if a third party acquires rights in assets described in a registered notice (for example, by gift or sale or as a result of insolvency or judgement enforcement proceedings) after registration takes place. If the requirements for creation have also been satisfied by the time a third party acquires rights in encumbered assets, the security right will be effective against the third party and its priority will be

determined according to the rules set out in chapter VII (see A/CN.9/631/Add.4). However, if the conditions for creation have not yet been satisfied, the third party will acquire the asset free of the subsequently created security right, notwithstanding that it has searched the registry and is aware of the notice filed by the secured creditor. Until both creation and registration have occurred, third-party effectiveness is not achieved.

36. The principle that third-party effectiveness dates from the time both requirements are met, and not necessarily from the time of registration, is subject to one important exception. As a general rule, in order to promote certainty and transparency among secured creditors, priority among competing security rights that have been made effective against third parties by registration is made to depend on the order of registration, not the time of creation (see A/CN.9/631, recommendation 78). That is, as between two secured creditors, one of which has registered first, but created its security right after the other has both created its security right and registered a notice, the first register will have priority.

(d) Extension of registry system to other transactions

37. The establishment of a general and comprehensive security rights registry system of the kind contemplated by this Guide enables searchers to discover potential encumbrances on a grantor's assets and to take steps to protect their rights. States that have adopted these types of registries have also tended to expand their scope. That is, these States have concluded that, even though the primary purpose of the registry is to serve as a repository of information about potential security rights, it can also serve to record information about other types of non-possessory rights in movable property. The registries have been extended to embrace registration of a wide variety of notices indicating that a non-possessory right exists, or that some other intangible right may exist in favour of a third party.

38. The idea of using a security rights registry for other purposes is not novel. Many States that have established specialized registries to record the pledge, hypothecation, mortgaging or assignment by way of security of claims to payment (for example, a right to an insurance payment, or commercial receivables) also provide that the outright assignment of an individual payment claim, or an entire category of payment claims may (and in some cases, must) be registered in the specialized registry in the same manner as if it were a security right. Typically, in States that have adopted comprehensive security rights registries, registration is mandatory in the sense, in the absence of registration or completion of another third-party effectiveness step, the security right is not effective against third parties (in other words, registration is non-mandatory in the sense that its absence does not affect the effectiveness of the security right as between the parties). An outright assignee of receivables is subject to the same registration requirements for third-party effectiveness and the same priority rules that apply to the holder of a security right in receivables. The rationale is that there is little practical difference, from the perspective of the rights of third parties, between an outright assignment and a security assignment and that, consequently, the rules for effectiveness against third parties of both types of transaction should be the same. This is the approach recommended by this Guide (see A/CN.9/631, recommendation 33).

39. In general, States have not sought to require owners of movable property to register their ownership. So, for example, while many States either require or enable

the registration of leases of immovable property, only a few extend this idea to movable property. Nonetheless, States that have established a general security rights registry tend also to make registration in this registry a condition for the third-party effectiveness of transactions where there is a disjuncture between the owner and the person that, over a period of time, has possession of an item of movable property and appears to use it as if it were an owner. The two most common situations involve true leases of significant duration (for example, one year or longer) and commercial consignments in which the consignee is in possession of inventory as an agent for sale on behalf of the owner. In States that adopt this approach, the rights of the lessor and the consignor against third parties are subject to the same third-party effectiveness and priority rules that apply to the holder of an acquisition security right. The rationale for this approach is that in the absence of registration, third parties dealing with the lessee's or consignee's business assets have no objective means of determining whether they belong to the lessee or consignee or to a lessor or consignor.

40. The extension of the registration requirements for security rights to true leases is reflected at the international level in the Convention on International Interests in Mobile Equipment, which extends the scope of the international registry contemplated by the Convention beyond security rights and financial leases to include leasing arrangements.

41. Many States have long known of the concept of a judicial hypothec, under which a judgement creditor may register the judgement for a sum of money against the immovable property of a judgement debtor, and thereby obtain a security right in that immovable property. As the concept of a registrable non-possessory security right in movable property developed, some States began to permit the registration of judgements against movable property. States that have adopted a general security rights registry tend to provide for registration of a notice of a judgement indexed according to the identity of the judgement debtor. In States that adopt this approach, registration creates the equivalent of a security right in the movable property of the judgement debtor in favour of the judgement creditor. This approach can indirectly promote the prompt voluntary satisfaction of judgement debts, since third parties will be reluctant to buy or take a security right in the encumbered assets until the judgement debtor has paid the judgement debt and brought about a termination of the registration.

42. In States that adopt this approach, the judgement debtor's insolvency representative is typically entitled to claim the monetary benefit of a registered judgement creditor's priority for the benefit of all unsecured creditors (sometimes subject to a special privilege in favour of the registered judgement creditor to compensate for expenses and efforts). The purpose of this rule is to ensure that the registered judgement creditor's rights do not conflict with insolvency policies requiring equality of treatment among the debtor's unsecured creditors. The Guide does not make a recommendation on this point, since it is an issue for law other than secured transactions law (as to the priority between a secured creditor and a judgement creditor, see A/CN.9/631, recommendation 90).

3. Possession

(a) General

43. In virtually all States, a transfer of possession of tangible assets to the secured creditor (the classic possessory pledge) is accepted as sufficient to both evidence the creation of a security right and make it effective against third parties. At the level of creation, this is based on the theory that the transfer of possession evidences the grantor's implicit consent to the security right and the scope of the assets encumbered by that security right. At the level of third-party effectiveness, while a transfer of possession does not positively publicize the existence of a security right (for example, it does not necessarily mean that the person in possession is a pledgee rather than a lessee, a borrower or a mere depositary), it does eliminate the risk that third parties will be misled by the grantor's possession into thinking that the grantor holds an unencumbered title to the property.

44. While historically possession was often the exclusive method for adverting third-parties to the existence of a security right, over the twentieth century many States also developed specialized registries for certain categories of movable property. For example, some States created registers for non-possessory pledges of commercial or industrial equipment. The existence of a register for non-possessory commercial pledges was not, however, accompanied by a general prohibition on the "true" pledge of this type of asset. As a result, it was often possible that competing possessory and registered security rights could encumber the same asset. A similar result is possible in States that have established general security rights registries. Registration of a notice in a registry system for security rights is seen as an alternative method for achieving third-party effectiveness that co-exists with specialized registration systems or grantor dispossession.

45. The idea of maintaining the approach that contemplates the co-existence of these methods of achieving third-party effectiveness is not without controversy. Two intertwined rationales are advanced for abolishing possession as a method for achieving third-party effectiveness wherever a general security rights registry exists. The first is that possession detracts from the reliability of the registry record as a comprehensive source of information about the potential existence of security rights in a grantor's assets. Prospective secured creditors or buyers cannot rely on a negative search of the registry to conclude that the relevant asset is unencumbered. They must also verify that the asset is in the grantor's possession. The second rationale relates to difficulties of proof. Whereas the registry offers a reliable public record of the relevant time for establishing priority between a security right and the right of a competing claimant, possession requires potentially contested evidence of when the physical transfer of possession actually occurred.

46. Despite these concerns, States that have established general security rights registries invariably also retain transfer of possession as an equally valid alternative method for achieving third-party effectiveness of a security right in tangible property. The reasons for doing so are several. The sufficiency of possession for third-party effectiveness is well established in commercial practice. Moreover, transfer of possession as a method of third-party effectiveness would need to remain available in any event for negotiable documents and negotiable instruments in order to preserve their negotiability and the associated priority. As for the intrusion on the comprehensiveness of the registry record, a prospective secured creditor or buyer

will usually need to verify whether the relevant assets actually exist and, for this purpose, it will typically be required to verify the grantor's continued possession. Similarly, evidentiary problems relating to the time of the transfer are unlikely to pose difficulties in practice. In its own self-interest, a prudent secured creditor will want to ensure that the time at which it acquired possession is well documented.

47. States that maintain both registration and creditor possession as methods for achieving third-party effectiveness also adopt the principle that, except in very limited cases, these two methods produce exactly the same consequences (both as to the time at which the security right actually becomes effective against third parties, and as to the priority consequences attaching to these additional steps). This said, however, as a practical matter these are not equal methods for achieving third-party effectiveness. First, transfer of possession is an available method of third-party effectiveness only if the asset in question may actually be possessed (that is, is a corporeal, tangible asset). Second, transfer of possession is viable only where the grantor is prepared to give up ongoing use and enjoyment of the encumbered assets. It is not feasible if the grantor needs to retain the encumbered assets in order to produce its services or products or otherwise generate income.

48. For these two reasons, once a comprehensive and efficient notice registration system becomes available, the vast majority of secured creditors tend to prefer registration to possession as a method for achieving third-party effectiveness. The two main exceptions are transaction-specific and usually involve short-term financing. So, for example, where possession confers a priority advantage, as in the case of negotiable instruments and negotiable documents, secured creditors will take possession even if they or any other party may have already registered a security right (see A/CN.9/631, recommendations 99 and 107). In addition, where the secured creditor is in the business of taking possessory security rights (as is the case with pawnbrokers) it is rare that it will also register its security right. Given that the possessory pledge is well-known and well-understood in most States, that there can be efficiencies in permitting possession as a method for achieving third-party effectiveness, and that the disruptions to the integrity of the registry are not significant, this Guide follows the position of those States that have adopted a general security rights registry and endorses both registration of a notice and transfer of possession to the secured creditor as a method for achieving third-party effectiveness (see A/CN.9/631, recommendation 38).

(b) Constructive possession insufficient

49. While the pledge originated in the actual transfer of a specific item of tangible property from the grantor (pledgor) to the secured creditor (pledgee), over time States sometimes relaxed the rules as to what might constitute creditor possession. In some States, constructive possession (for example, an agreement appointing the grantor as the secured creditor's agent) is now accepted as sufficient to constitute and give third-party effectiveness to a security right in tangible property. In other States, possession may be symbolic, as when a grantor affixes a notice to an object or to the door of an establishment stating that the object or contents of the establishment have been pledged to the secured creditor. These developments were usually the result of an absence of a more general mechanism for creating a non-possessory pledge (or security right) in movable property. This said, some States that today do not permit non-possessory security rights maintain a strict requirement

that the creditor's possession be real: public, continuous, peaceful and unequivocal (for a discussion of possession as condition of creating a possessory security right, see A/CN.9/631/Add.1, paras. ...).

50. States that have established a general security rights registry and that continue to allow creditor possession as a method of third-party notice invariably adopt the strict approach to possession. Creditor possession requires real relinquishment by the grantor of physical control over the encumbered assets. Continued possession by the grantor or anybody closely associated with the grantor would not provide a sufficient signal to third parties that the grantor's title is potentially encumbered. That is, because the existence of a security rights registry enables debtor-in-possession security, there is no need to relax the concept of possession to facilitate the creation of security rights. This is also the approach recommended by the Guide and its rationale (for the definition of "possession", see A/CN.9/631/Add.1, para. 9).

(c) Possession by a third party

51. It is widely accepted, regardless of whether a State has established a general security rights registry, that possession need not involve direct custody by the secured creditor. Possession by an agent or representative of the secured creditor is sufficient to possession by the secured creditor, provided that an objective bystander would not conclude that the encumbered assets remain in the grantor's possession. There are various means by which third-party possession may be effected.

52. In some cases, the secured creditor has neither the capacity nor the expertise to properly safeguard encumbered assets. Here, a depositary acting for the secured creditor will typically take or receive possession in the secured creditor's name. In other cases, the encumbered assets may already be in the custody of a third party at the time the security right is created. For example, these assets may be diamonds, gold, jewellery or other precious metals in the safe keeping of a security company. In these cases, it is necessary for the holder to be informed that the grantor has pledged the property, and that until receipt of a notice from the secured creditor it may not release the property to the grantor.

53. More commonly, existing third-party custody arises because a third-party carrier or warehouse-keeper holds the encumbered asset. Here, a form of third-party effectiveness through possession can occur when the third party issues a receipt in the name of the secured creditor or agrees to hold the encumbered assets on behalf of the secured creditor. In this case, the third party's actions confirm that it is in possession on behalf the secured creditor.

54. Alternatively, if the document of title is issued in negotiable form, this means the carrier or warehouse keeper is obligated to deliver the assets represented by the document to the person currently in possession of it. Delivery of the document with any necessary endorsement to the secured creditor therefore offers an alternative means of achieving third-party effectiveness of a security right in the assets it represents.

55. In some States, the idea of third-party possession by a depositary or warehouse-keeper has been extended to ad hoc arrangements between the parties. That is, in these States, a transfer of possession to the secured creditor's agent need not even require physical removal of the encumbered assets from the grantor's premises. In "field warehousing" arrangements, for example, a representative of the secured

creditor (typically an employee of the grantor) takes physical custody of the encumbered assets on the grantor's premises (for example by placing them in a locked store room to which only the representative has the key). Any release of the assets in the "field warehouse" to the grantor requires the consent of the secured creditor.

56. Field-warehousing arrangements are most common in States in which the possessory pledge is the only available form of security in movable property. Nonetheless, even in States that offer the alternative of a public registry, a secured creditor may still wish to engage in field warehousing as a practical monitoring technique. However, it will generally also register a notice of its security right to ensure real certainty with respect to third-party effectiveness and to avoid the risk that the arrangement will be challenged as involving constructive rather than real possession.

57. In States that maintain creditor possession as a method for achieving third-party effectiveness, the possibility that this creditor possession may be exercised through the custody of an agent or representative is an important feature of modern regimes of security rights. It enhances the efficiency and effectiveness of possessory security rights, while lowering its cost by permitting creditors to delegate custodial responsibility to experts. For these reasons, this Guide foresees that creditor possession may be effected through third-party custody (see definition of "possession" in A/CN.9/631/Add.1, para. 19).

(d) Inapplicability of possession to intangible assets

58. Underlying the idea of possession as a possible method of achieving third-party effectiveness is the idea that physical custody of an asset is transparent. This is why, both historically and today, States that authorize security through pledge agreements require the encumbered assets to be tangible property. Intangible assets are excluded because it is not physically possible to take possession of an intangible asset. Very often, a creditor seeks to take a security right in the grantor's receivables, but cannot achieve third-party effectiveness of its security right by possession. Only if the receivables are made corporeal in a negotiable instrument can creditor possession constitute a method for achieving third-party effectiveness. A deposit certificate or other instrument that merely evidences a debt, but that is not negotiable, cannot be the subject of "possession". Likewise, should a grantor seek to create a security right in a lease of a piece of equipment, it could not achieve third-party effectiveness by handing over either the equipment (which it does not own) or the lease contract to the secured creditor.

(e) Adequacy of possession for the purposes of enforcement

59. Not all secured creditors will immediately seek to achieve third-party effectiveness of a security right. For whatever reason, they may neither register a notice in the general security rights registry, nor take possession of the encumbered assets. In States that consider the pledge to be a property contract, the absence of creditor possession means that the pledge is never constituted, even as between the parties. In other States, most commonly those that have adopted a general security rights registry but that also provide for creditor possession as a method for achieving third-party effectiveness, the pledge may be constituted between the parties even without creditor possession. In these cases, it is necessary to determine

the conditions under which subsequent actual creditor possession will constitute a method for achieving third-party effectiveness.

60. In some States, a security right is not made effective against third parties by possession when possession results from seizure by the secured creditor as a result of the grantor's default. This approach has both a conceptual and policy rationale. Conceptually, the voluntary surrender of possession by the grantor to the secured creditor at the outset of the secured transaction involves recognition by both parties that the secured creditor's rights are to be protected in this way. Seizure for the purposes of enforcement usually involves the involuntary taking of the encumbered asset from the grantor as a result of the grantor's default. Moreover, even where the grantor voluntarily surrenders the asset, it does so under the coercive threat of enforcement proceedings. The policy rationale rests on the fact that seizure for enforcement purposes typically will be relied upon by a secured creditor that has failed to register notice of its security right or has failed to register it properly. Particularly in the context of a competition with the grantor's insolvency representative, there are concerns that recognition of seizure as a sufficient act of third-party effectiveness would reward imprudent conduct, encourage precipitous enforcement action, and involve difficult questions of proof as to whether the seizure occurred before or after the commencement of the insolvency proceedings.

61. In other States, by contrast, the motivation and context of creditor possession is held not to be relevant to determining its consequences. Creditor possession results in third-party effectiveness even when the secured creditor obtains possession through seizure of the encumbered assets for the purposes of enforcement. This approach is based on the theory that the function of possession is to ensure that third parties are not prejudiced by the grantor's remaining in possession of assets to which it does not hold unencumbered title. Possession by the secured creditor serves this goal regardless of the motive for taking possession. Because the primary context in which this policy issue arises involves a competition between the secured creditor and the grantor's insolvency representative, this Guide does not contain a recommendation on the point, but defers to a State's insolvency regime.

4. Registration in a specialized registry or notation on a title certificate

(a) General

62. The two main approaches to achieving third-party effectiveness just reviewed (registration in a general security rights registry and creditor possession) presuppose that the central objective is to alert third parties to the possible existence of a security right. Even in States that heretofore have established fragmented registries, that is, registries in which the organizational structure focuses on the type of transaction (for example, retention-of-title, or commercial pledge registries), or the status of the grantor (for example, corporation registries), or the identity of the secured creditor (for example, banks), or the type of encumbered assets (for example, equipment or receivables registries), the focus of the registry is on security rights. Only by exception are these registries open for registrations that are not, or not intended as, security rights (for example, outright assignments of receivables, long-term leases, commercial consignments).

63. In many States, however, there have traditionally existed other forms of publicizing rights. On occasion, a specialized, asset-specific registry may be

established to record all transactions related to that type of asset. The model for these types of registry is the standard register of rights in immovable property, in which title, encumbrances, public charges and even caveats about impending litigation can often be registered. States also create systems where certain types of movable property are identified by a title certificate, and various transactions relating to that property (including security rights) may be directly noted on the title certificate. The common features of these two approaches to publicizing rights are that (i) the mechanism in question is created only in respect of certain, identified assets and (ii) all types of rights (and not just security rights) may be recorded and publicized. These mechanisms have proved their usefulness over time, such that even in States that have established general security rights registries, they are often maintained as alternative methods to registration and creditor possession for achieving third-party effectiveness.

(b) Registration in a specialized movable property registry

64. As noted, a general security rights registry in which parties may register a notice about a potential or existing security right can be an effective way of alerting third parties to the need to verify carefully the status of a grantor's rights in the movable property with which it proposes to deal. However, sometimes a specialized registry for particular assets can be just as operationally efficient while also serving important broader functions that cannot be replicated by a general security rights registry. For example, ship and aircraft registries are two widely recognized instances where a specialized registry functions to address international regulatory concerns about safety and national concerns of State security in addition to facilitating commercial transactions.

65. For these reasons, many States recognize that registration in a specialized registry already existing under other law may be an alternative method of achieving third-party effectiveness for security rights in assets covered by the regime (see A/CN.9/631, recommendation 39). Typically, the logistics of registration in a specialized title registry are not addressed in secured transactions laws, since this is a matter for the specialized law governing that regime. Frequently, the existing system requires, in the manner of many security rights registers that developed in the nineteenth and twentieth centuries, the registration of the security documentation, or the registration of a summary of that documentation that is certified by the registrar. The rationale for adopting a "notice-filing" approach in the case of a general security rights registry should equally apply to these specialized asset registries. States maintaining such registries might, therefore consider whether they should adopt a notice system as a complementary reform aimed at enhancing the efficiency of the registry.

66. Registration of a notice about a security right in principle can be made available even in registry systems that function first and foremost as title registries. In the case of a transfer of ownership, these registries typically require evidence of the underlying transfer documentation, since registration of an unauthorized transfer may prejudice a secured creditor or purchaser that relies on the ownership registry record. However, the same level of proof is unnecessary for security rights, since a registry search that discloses a security right when none in fact exists has no detrimental effect in itself. Potential purchasers and secured creditors can protect themselves by refusing to purchase or to lend except on terms that take account of

the registered security right with the result that the grantor will take action to have any of (i) an unauthorized registration, (ii) a continuing registration after the secured obligation has been paid, or (iii) a registration in respect of which no security agreement was ever executed, expunged from the record.

67. States that maintain specialized registries must determine whether registration in the specialized registry will be the exclusive method of achieving third-party effectiveness of security rights over the assets covered by it. Some States take this position. No rights in the asset may be claimed as against third parties if notice of those rights is not given in the specialized registry. Other States adopt a less absolute position and permit alternative methods for achieving third-party effectiveness of security rights in assets covered by the specialized registry. In these States, the rationale is that, with the exception of competing claimants whose rights are sought to be protected by the specialized title regime and that have prejudicially relied on the register, there is no reason why third-party effectiveness against all other claimants could not be achieved by other generally available methods. It follows that the secured creditor should also be permitted to make its security right effective against third parties by registration in the general security rights registry or by a transfer of possession of the encumbered assets.

68. It is important to be clear about the scope of the stated exception for actual detrimental reliance. The idea is that, even though the security right is effective against third parties, its priority when made effective by one of these other methods is subordinated to competing secured creditors and buyers that register their rights in the specialized registry. The subordination exists regardless of the respective time of the registration in the two registries. This approach enables a secured creditor that takes a security right in all of the grantor's movable assets, or in generic categories of them, to protect itself against the grantor's insolvency representative or judgement creditors by making a single registration in the general security rights registry. Registration in the specialized registry is necessary only if the secured creditor concludes that the risk of an unauthorized grant of security to a competing secured creditor or sale to a buyer that registers in the specialized registry is sufficiently high to warrant the burden of making an additional registration in the specialized registry. In view of the limited number of these specialized registries and the types of assets they envision, the creation of a superior priority right to those that use the specialized registry does not significantly compromise the efficiency and integrity of the general security rights registry. For these reasons, the Guide recommends that, where specialized registries are maintained, third-party effectiveness may nonetheless be achieved by alternative methods such as registration in the general registry or creditor possession, subject to protecting the superior priority position of registrants in the specialized registry (see A/CN.9/631, recommendations 39, 83-84).

(c) Notation on a title certificate

69. Although most States have registration systems for the ownership and the transfer of ownership of motor vehicles and similar assets, these registry systems are generally not treated as establishing ownership for the purposes of commercial transactions and for that reason are not searchable by the public. Rather their purpose is primarily regulatory, namely to enable the authorities to trace ownership

in the event of an accident, or breach of criminal or safety standards and to allocate compulsory insurance liabilities and obligations.

70. These regimes usually provide the owner with a certificate of registration and a sale of the vehicle is invariably accompanied by the relinquishment of the old certificate to the appropriate regulatory authority and the issuance of a new certificate in the name of the new owner. In some States, notably those that have not established a general security rights registry, the title registration certificate is deployed as a basis for publicizing security rights in the asset represented by the registration certificate. In these States, a notation of the security right on the face of the certificate is treated as sufficient for third-party effectiveness of the indicated security right.

71. In States where this kind of certificate notation system is already in place and appears to be working well in practice, there may be little reason to abolish the system when a modernized regime of security rights is put into place. Nonetheless, it will be necessary to address the interrelationship of the existing system to the other methods of third-party effectiveness permitted under a new regime. Typically, notation on a title certificate is a sufficient method for obtaining third-party effectiveness of a security right in a tangible asset subject to the system. Registration in the general security rights registry and the taking of possession by the creditor are two other methods. However, if either of these latter methods is used, the priority of the security right to which they relate will be subordinated to the rights of a competing buyer or secured creditor that has relied on the certificate notation system. As with the approach taken to registration in a specialized title registry, this approach is intended to protect the reliability of and integrity of the title certificate system while enhancing the flexibility and efficiency of the general secured transactions system. The Guide recommends this approach (see A/CN.9/631, recommendations 39, 83 and 84).

5. Automatic third-party effectiveness of a security right in proceeds

72. It is inherent in the nature of movable property that it may be sold and re-sold during the period when the secured credit remains unpaid but not in default. The sale or other disposition of secured assets will normally give rise to proceeds (for the definition of “proceeds”, see A/CN.9/631/Add.1, para. 19), whether in the form of cash, negotiable instruments, receivables, other property received in exchange, or some combination of all of the above. In many States, a security right in any proceeds (including proceeds of proceeds) derived from the originally encumbered assets is automatically created as soon as these proceeds arise provided they remain identifiable. This is the approach recommended in this Guide (see A/CN.9/631, recommendation 18). However, this is not the only question that needs to be addressed. It is also necessary to determine whether the secured creditor should have to register or take some other step to make the security right in the proceeds effective against third parties.

73. While notices registered in a general security rights registry are organized and indexed by reference to the identity of the grantor, the registered notice must set out a description of the encumbered assets (see A/CN.9/631, recommendations 58 and 64). Thus, it is necessary to first distinguish the situation where the security right in the originally encumbered assets was made effective against third parties by registration and the proceeds are of a kind that falls within the description in the

registered notice. For example, if the registered notice describes the encumbered assets as “all present and after-acquired tangible property” and the grantor sells a farm tractor and uses the proceeds to purchase a sailing yacht, the description in the registered notice includes the proceeds as originally encumbered assets in the form of after-acquired tangible property. As registration may be made in advance of the creation of a security right, in principle the original registration is sufficient to give third-party effectiveness to the security right subsequently created in the proceeds when they arise. Most States that provide for an automatic right in proceeds also provide for automatic third-party effectiveness in these cases, and this is the result that is recommended in this Guide (see A/CN.9/631, recommendation 40).

74. More difficult questions arise when the security right in the originally encumbered assets is made effective against third parties by means of a notice in which the description would not point to the assets received as proceeds or by a method that would be insufficient if the proceeds were originally encumbered assets. In the above-mentioned example, to consider the first case, if the registered notice described the originally encumbered assets as “all present and after acquired farm equipment”, this description would not cover the sailing yacht. As for the second case, if the originally encumbered asset is a right to payment of funds credited to a bank account made effective against third parties by control, and the grantor withdraws funds without authority to purchase a sailing yacht, the method of third-party effectiveness used for the originally encumbered assets would not be sufficient for the proceeds.

75. These examples raise competing policy considerations. To give automatic third-party effectiveness to the security right in the proceeds undermines the policy underlying the third-party effectiveness requirements, since third parties would not be alerted to the potential existence of the security right in the proceeds. After all, a prospective purchaser of a sailing yacht from the grantor will not necessarily appreciate that a registered notice referring to a security right in farm equipment also covers the sailing yacht as proceeds. On the other hand, to require the secured creditor to take immediate steps to make the security right in the proceeds effective against third parties may impose an excessive monitoring burden and priority risk. The proceeds will often have arisen as a result of the grantor’s unauthorized dealing with the originally encumbered assets. In such cases, the secured creditor will usually not become aware of the unauthorized disposition until well after the fact. If the disposition were, in fact, unauthorized, the secured creditor would generally be entitled to follow the originally encumbered asset into the hands of a transferee, and would therefore not suffer any prejudice. However, it may not always be possible after the fact to locate the asset or the transferee, and in some cases the amount of the proceeds received might actually be higher than the value of the assets at the time it becomes necessary to enforce the security right.

76. In seeking to achieve a reasonable balance between these competing policies, most States that provide for an automatic creditor right in identifiable proceeds typically treat a security right in proceeds that would not be covered by the initial description of the encumbered assets as automatically effective against third parties, either permanently or only for a temporary period. The extent and duration of third-party effectiveness in these States depends on the nature of the initially encumbered assets and the nature of the proceeds.

77. Permanent third-party effectiveness is given to a security right in proceeds that take the form of money, receivables, negotiable instruments and rights to payment of funds credited to a bank account (for the definitions of these terms, see A/CN.9/631/Add.1, para. 19). This approach is based on the idea that the absence of an independent act of third-party effectiveness for these types of proceeds does not pose any significant risk of prejudicial reliance for third parties. In the case of money and negotiable instruments, this is because subsequent transferees or secured creditors that take possession generally take free of a security right in any event (see A/CN.9/631, recommendations 99 and 104). As money and negotiable instruments are typically derived by the grantor from the collection of receivables (proceeds of proceeds), it would be illogical and counterproductive to not extend automatic third-party effectiveness to the original proceeds, the receivables. Money and negotiable instruments collected from receivables are typically then credited to the grantor's bank account (proceeds of proceeds of proceeds). A transferee of funds from the account generally takes free of any security right so the absence of publicity does not prejudice their rights (see A/CN.9/631, recommendation 103). As for secured creditors and assignees that take security in the right to payment of the funds in the account, the Guide recommends that priority be given to a secured creditor that achieves third-party effectiveness by control and to the depository bank's right of set off (see A/CN.9/631, recommendations 101-102). Consequently, with respect to these types of asset, competing claimants must be taken to know that they risk subordination in any event unless they protect themselves by assuming control of the account. Given these considerations, in order to ensure the coherence of the regime governing proceeds in the form of money, receivables, negotiable instruments and rights to payment of funds credited to a bank account, most States provide that permanent third-party effectiveness in these assets is automatic. It is also the result recommended in this Guide (see A/CN.9/631, recommendation 40).

78. For other types of proceeds, a different set of policies are in play. It may well be that the disposition giving rise to the proceeds is unauthorized and that the creditor does not quickly become aware of the disposition. Hence, it is reasonable to provide that the security right is automatically effective against third parties. However, by contrast with money and money-like proceeds, proceeds that take the form of tangible assets appear to third parties as property of the grantor. Where they do not fall within the initial description therefore, third parties can easily be misled. For this reason, and in order to avoid unduly undermining the rights of third parties, most States provide that the automatic third-party effectiveness will last only for a short period of time after the proceeds arise. To achieve permanent third-party effectiveness, the secured creditor must register a notice or otherwise take positive steps to make the security right effective against third parties before the expiry of that period. Obviously, the temporary period must be relatively short and yet not so short as to deprive a reasonably prudent secured creditor from the opportunity to take steps to preserve the third-party effectiveness of its security right. A period of twenty to thirty days seems to be the compromise that most States find acceptable. This Guide adopts the logic of a short temporary automatic third-party effectiveness period within which the secured creditor must amend the description of secured assets so as to cover proceeds of a type different from the assets initially encumbered (see A/CN.9/631, recommendation 41).

6. Third-party effectiveness of a security right in attachments

(a) General

79. An asset encumbered by a security right that has been made effective against third parties may be attached, or may become attached, to other property (whether movable or immovable). For example, tires subject to a security right may later be attached to a truck, or a heating boiler subject to security right may later be attached to a building. In some States, attachment terminates the security right. This approach is based on policy concerns about protecting the position of buyers and other third parties that subsequently acquire rights in the property to which the encumbered asset is attached. In other States, only attachment to immovable property will terminate an existing security right in movable property that becomes an attachment. The policy in these States is to prevent subsequent detachment, and consequential deterioration of the immovable property while also preserving the priority of the rights of any creditor that has taken security over the immovable property prior to the attachment.

80. States that have adopted a comprehensive registry system for movable property resolve these policy concerns more directly by seeking a balance between competing rights. Most regimes are organized so as to permit the security right to survive attachment at least as between the parties. However, in order to address the respective rights of the secured creditor and third parties, these regimes also provide a full set of third-party effectiveness and priority rules. This is the general approach adopted by this Guide. Thus, chapter IV (see A/CN.9/631/Add.1) confirms that a security right may be created in tangible property that is an existing attachment, or that becomes an attachment subsequently, to the extent of the value of the tangible at the time of its attachment (see A/CN.9/631, recommendation 22). This chapter addresses the issue of third-party effectiveness, while chapter VII (see A/CN.9/631/Add.4) deals with priority.

(b) Attachments to movable property

81. If the tangible property subject to the security right is attached to other tangible property (that is, another movable object), the general requirements for third-party effectiveness apply. Attachments are not singled out for special treatment. Thus, if the security right is made effective against third parties by registration prior to attachment, it remains effective after attachment without the need for any further step (see A/CN.9/631, recommendation 42). This is because, unlike the situation where the originally encumbered asset is replaced by proceeds, attachments retain their discrete identity after they are attached to other property. Consequently, it is reasonable to assume that a third party that searches the registry for security rights in the property to which the attachment is attached (for example, an automobile) will understand that a registered notice that describes the attachment (for example, automobile tires) may refer to the tires installed on the automobile in which the third party is interested.

82. Theoretically, a security right in an attachment would also remain effective against third parties if the security right had been made effective prior to attachment by a transfer of possession to the secured creditor or to a third party agent of the creditor rather than by registration in the general security rights registry. However, as a practical matter, third-party effectiveness will typically cease upon attachment,

since the secured creditor will normally have to relinquish possession to allow the attachment to take place. Consequently, third parties that deal with the asset after attachment will take free of the security right, unless the secured creditor preserves its status by registering in the general security rights registry before giving up possession or before their rights arise. By contrast, if the secured creditor is also in possession of the movable property to which the attachment is made, or if an agent or representative of the creditor has possession of that property, third party-effectiveness is preserved (however, this will not be the usual case).

(c) Attachments to immovable property

83. If the encumbered asset is attached to immovable property, the policy considerations are more complex. This is because any rights that charge the immovable property will normally be registered in the immovable property registry. As between the parties, this Guide recommends that a security right in an attachment to immovable property may be created according to the principles elaborated in this Guide, or according to the regime governing rights in the immovable property. Consistently with this idea, the security right so created may be made effective against third parties either by registration in the general security rights registry or by registration in the immovable property registry (see A/CN.9/631, recommendation 43). However, if a security right is created under the regime governing movable property and the requirements for creation are not sufficient for creation under the regime governing immovable property, the rules governing the immovable property registry would have to be modified to nonetheless permit registration of the security right in the attachment. Moreover, the choice of method has priority consequences. Registration in the immovable property registry is necessary to achieve maximum protection against third parties. A secured creditor or buyer that registers in the immovable property registry has priority over a secured creditor that relies on registration in the general security rights registry (see A/CN.9/631, recommendation 93).

84. This special priority rule is necessary to preserve the reliability and integrity of the immovable property registry. It is workable only if registration of a security right in an attachment in the immovable property registry can be done easily and efficiently. The existing immovable property registry systems may require the submission of full security documentation or impose other formalities for registering security rights. If this is the case, land registration laws may need to be revised to authorize registration of a notice of a security right. Otherwise, the cost and expense involved in fully protecting their priority status by registering in the immovable property registry may deter secured creditors from engaging in secured financing that involves attachments to immovable property.

(d) Attachments to movable property subject to a specialized registry

85. It is quite common, in those States that have specialized title registries that the types of property subject to registration in these registries involve property to which other tangible property is normally attached (e.g. ships, aircraft, road vehicles). Because of the desire to protect the integrity of the special registry, States usually adapt the approach to a security right in tangible property that is attached to immovable property to the case of attachments to tangible property subject to a specialized title registry or title certificate system. The security right may be made

effective against third parties either by registration in the general security rights registry or by the creditor taking possession (although as noted above this will be rare), or by registration in the specialized registry or notation on the title certificate (see A/CN.9/631, recommendation 43). As with attachments to immovable property, registration in the specialized registry, or notation on the title certificate, is necessary to achieve maximum third-party protection. A secured creditor or buyer that relies on the specialized registry system has priority over a secured creditor that achieves third-party effectiveness by some other method (see A/CN.9/631, recommendation 93). In order to facilitate access to that system, it may be necessary to amend the law governing that system to ensure that the secured creditor can register a simple notice of the security right in the attachment or note it independently on the title certificate as the case may be.

(e) Coordination of registries

86. When States adopt the position that third-party effectiveness of a security right can be achieved by more than one method, they are required to decide whether all such methods produce identical consequences, or whether one or the other method may produce superior consequences. As noted, to preserve the integrity of registries other than the general security rights registry (the immovable property registry or the specialized title registry) registration in these registries gives the secured creditor the maximum priority protection. For this reason, it is invariably in the interest of a creditor that has registered in the general security rights registry to also register a notice in the specialized registry. Rather than requiring the secured creditor to itself effect a separate registration in the immovable property registry or specialized movable property registry, some States have a registry system in which security rights in attachments that are registered in the general security rights registry are automatically forwarded for registration in the other registry. However, since registrations in the immovable property registry system and in specialized movable property registries are indexed according to the asset, not the grantor, a registrant in the general security rights registry would have to provide the registry with the applicable asset description and specify expressly that a notice covering “all tangibles” includes attachments described specifically.

7. Automatic third-party effectiveness of a security right in a mass or product

87. For the reasons set out in chapter IV (see A/CN.9/631/Add.1, paras. ...), this Guide recommends that a security right in tangible assets that are later processed or commingled automatically continues in the finished product or commingled mass (see A/CN.9/631, recommendation 23). This recommendation does not, however, speak to whether the security right in the finished product or mass is effective against third parties. Assuming the security right in the component asset was made effective against third parties prior to the processing or commingling, the policy question is whether the security right that continues in the product or mass should be treated as automatically effective against third parties.

88. In the most common case, the security right in the originally encumbered assets will have been made effective against third parties by registration in the general security rights registry (since this is the only practically available method for inventory in the form of raw materials). It follows that States have to decide whether this initial registration is sufficient to achieve third-party effectiveness of the

security right in the product or mass derived from the processing or commingling of the originally encumbered assets.

89. As noted earlier, while notices in a general security rights registry are organized by reference to the identity of the grantor, the registered notice must set out a description of the encumbered assets (see A/CN.9/631, recommendations 58 and 64). Just as in the case in relation to third-party effectiveness of security rights in proceeds of disposition of encumbered assets, a distinction must be drawn based on the manner in which the initially encumbered assets are described. Consider first the situation where the registered notice describes the encumbered assets in a manner that covers both the originally encumbered asset and the resulting product or mass. For example, a registered notice may describe the encumbered assets as “wheat of xyz type or quality” and the grantor’s wheat is later commingled with other wheat of this same type or quality. Similarly, a security right may be taken in resin that is later manufactured into chipboard while the secured creditor registers a notice that describes the encumbered assets as “raw materials and finished inventory”. In both cases, a third party searcher will be alerted to the possible existence of a security right in the commingled mass or the manufactured product so there can be no policy objection to treating the original registration as sufficient to give third-party effectiveness to the security right that continues in the product or mass. Most States that have adopted a general security rights regime take this automatic third-party effectiveness approach to these types of cases.

90. More difficult policy concerns arise where the registered notice describes the encumbered assets in terms that include only the component but neither the commingled mass nor the finished product. For example, the secured creditor may have registered a notice that describes the encumbered asset as “wheat of xyz type or quality” and the wheat is then irretrievably commingled with a much greater quantity of wheat of “abc type or quality”. A third party searching the registry may not be able to discern the extent of the creditor’s rights in the commingled mass. An even more complicated situation arises where the secured creditor registers a notice that describes the encumbered asset as “resin” and the resin is later processed into chipboard. Here, a reasonable third party that searches the registry to determine whether there is any security right in the grantor’s chipboard may not understand that a notice referring to a security right in resin also extends to chipboard manufactured from the resin.

91. This second situation especially raises competing policy considerations. To give automatic third-party effectiveness to the security right in the chipboard may compromise the policy underlying the third-party effectiveness requirements, since the registered notice does not necessarily alert third-party searchers to the existence of the security right. On the other hand, to require a secured creditor to also include a description of the resulting product or mass in its registered notice may discourage financing against the security of a grantor’s raw materials or lead to the registration of notices containing overly broad descriptions (as in the example given above where the notice refers to “inventory” even though the security right is limited to resin) to the detriment of the grantor’s access to secured credit from other sources.

92. In resolving these competing policies, States take different approaches. In some States, the security right is treated as automatically effective against third parties without the need for any further act. This approach is based on the theory that the risk of detrimental reliance by third parties is minimal in practice. Subsequent

secured creditors will be sufficiently knowledgeable about the grantor's manufacturing operations to understand that a registered notice that refers to a security right that describes only the component assets also covers any finished product processed from those assets; and subsequent buyers will generally be protected since the finished product or commingled mass will typically constitute inventory sold in the ordinary course of the grantor's business and a buyer in the ordinary course takes free of a security right in any event.

93. In other States, the security right is treated as automatically effective only as against other secured creditors. If the competition is with someone other than another secured creditor (for example, a non-ordinary-course buyer or a judgement creditor or insolvency representative), the security right is ineffective unless a notice that describes the encumbered asset in terms that include the product or mass is registered before these other rights arise. This approach is based on the theory that, unlike the grantor's secured creditors, these other categories of third-party claimants are more likely to be misled by a description in a registered notice that includes only the raw materials and not the finished product into which they are incorporated.

94. The Guide recommends the first of the two approaches just outlined. That is, it recommends that States adopt a rule to the effect that if the security right in the component asset is effective against third parties, the security right in the resulting product is automatically effective against third parties without the need for the secured creditor to take any further step (see A/CN.9/631, recommendation 45). This choice is based on two considerations. First, in practice it is highly unlikely that a finished product or commingled mass will be sold to a buyer outside the ordinary course of business, since these assets will almost invariably form part of the grantor's inventory. Second, unsecured creditors generally do not look to a grantor's inventory for the purposes of satisfying their judgements, since the grantor is more likely to be in a position to pay their claims if it is able to continue selling its inventory in the ordinary course of business.

8. Continued third-party effectiveness of a security right after a change in the location of the asset or the grantor

95. A change of location is inherent in movable property and persons. Sometimes property or persons move to a different location within the same State. Sometimes, they move to a location in a different State. Where third-party effectiveness is achieved by registration in a general security rights registry, the criteria for searching the registry relate to the name of the grantor. Hence a change of physical location within the same State will not compromise a searcher's capacity to determine if a security right has been created, and therefore should have no impact on the continued third-party effectiveness of the security right. This is not the case, however, where the asset or the grantor moves from one State to another.

96. As explained in chapter XIII (see A/CN.9/631/Add.10, paras. 26-27 and 35-40), the law applicable to the third-party effectiveness of security rights is determined by reference to the current location of either the encumbered assets or the grantor depending on the nature of the encumbered assets (see A/CN.9/631, recommendations 202 and 204). This approach is based on the theory that third parties that deal with the encumbered assets following the change of location cannot be expected to undertake an extensive historical investigation into whether the encumbered assets were previously subject to a different law. However, this

approach creates significant risks for secured creditors. Third-party effectiveness ceases as soon as the location of the assets changes unless the security right is made effective against third parties under the law of the new location. While the secured creditor can protect itself if it has advance knowledge of the change of location, in the typical situation this will not be the case.

97. In an effort to balance the competing rights of secured creditors and third parties in this situation, some States provide a period of temporary automatic third-party effectiveness following a relocation of the assets within their own borders or the relocation of the grantor to that State. Under this approach, a security right that was made effective against third parties under the law of the previous location is treated under the law of the State to which the grantor or the assets are relocated as automatically effective against third parties for a short period after the relocation. If the security right is made effective against third parties in accordance with the law in the new location of the grantor or the assets before the expiry of this period, it continues to be effective against third parties that acquire rights in the encumbered assets after the relocation, even if these rights were acquired before the pre-existing security right was made effective against third parties under the law of the new location. If third-party effectiveness in accordance with the law in the new location of the grantor or the assets is not achieved before the expiry of this period, the security right is ineffective against third parties that acquired rights during the short period.

98. The Guide adopts this approach (see A/CN.9/631, recommendation 46), offering a reasonable balance between accommodating the rights of secured creditors and third parties that deal with the grantor or the assets following relocation. On the one hand, the secured creditor is given a reasonable time period to take action to protect its rights. On the other hand, a defined time period enables a third party that acquires rights in the encumbered asset after the relocation to take effective protective measures such as withholding a loan or extension of credit or the purchase price pending the expiry of the short period of automatic third-party effectiveness, since the third party can rely on taking free from any foreign security right not otherwise made effective against third parties before the expiry of that period.

9. Continuity and lapse of third-party effectiveness

99. As already mentioned, most States that have adopted a general security rights registry system as a method of achieving third-party effectiveness also permit alternative methods for achieving third-party effectiveness (e.g. possession by the creditor, the execution of a control agreement respecting funds in a bank account, registration in a specialized registry, notation on a title certificate). Often, a secured creditor may achieve third-party effectiveness using more than one method at the same time. Moreover, sometimes, a creditor may change the method by which third-party effectiveness is achieved (e.g. a secured creditor that has taken possession may later file a notice of the security in the general security rights registry). Most of these States provide that continuity of third-party effectiveness is preserved, notwithstanding a change in the method of third-party effectiveness, as long as there is no time when the security right is not effective against third parties under one or more method. This is the approach recommended in this Guide (see A/CN.9/631, recommendation 47).

100. Conversely, there can be situations where third-party effectiveness lapses. Consider the case where the requirements for third-party effectiveness under one method no longer apply and the secured creditor does not achieve third-party effectiveness through another permissible method before the time of lapse (e.g. registration may expire or be cancelled or the secured creditor may relinquish possession of the encumbered asset or the circumstances that resulted in automatic third-party effectiveness may no longer prevail, and the secured creditor has not taken steps to achieve third-party effectiveness using another method). In this situation, third-party effectiveness lapses, and would have to be re-established after the lapse. States take different approaches to the effect of a lapse and re-establishment.

101. Some States consider that the lapse is fatal to the continuity of the third-party effectiveness and any re-establishment can only produce effects from that moment onward. The policy here is to avoid requiring competing claimants having to go behind the registry record in order to determine if a security right ever existed. Other States provide for a grace period within which a lapsed registration may be re-established. In these States, if third-party effectiveness is re-established within a short delay, it will be deemed to have been continuous, and the initial priority of the secured creditor will be maintained, except as against competing claimants that acquired rights in the encumbered assets during the period of the lapse. The policy here is to permit a secured creditor that may have inadvertently let third-party effectiveness lapse to correct its mistake, as long as no third party suffers prejudice as a consequence.

102. In deciding which of these approaches to adopt it is helpful to analyse the general consequences likely to flow from a failure to preserve continuity of third-party effectiveness. Two situations are particularly telling. The first is where a third party (such as a buyer or insolvency representative or judgement creditor) acquires rights in the encumbered assets after a lapse and before third-party effectiveness is re-established. Since the security right was not effective against third parties at the relevant time, these intervening third parties will acquire the encumbered assets free of the security right. Either of the two approaches will produce this result.

103. The second instance of concern arises where the right of a secured creditor, prior to the lapse, had priority over the right of a competing secured creditor. Priority among competing secured creditors, as a general rule, is based on the order of registration or third-party effectiveness (see A/CN.9/631, recommendation 78). On one approach, if third-party effectiveness lapses, priority dates only from the time when it is re-established. The lapsed security right will be subordinated to a competing security right that is registered or made effective against third parties before or during the period of lapse. On the other approach, priority would be re-established as of the initial time as against all secured creditors that registered or made their rights effective as against third parties before the period of lapse, but not as against secured creditors that registered or made their security right effective as against third parties during the period of the lapse.

104. The discussion in the preceding paragraph refers to registration as distinct from third-party effectiveness. The reason for this is that registration, unlike the other modes of third-party effectiveness, may precede creation of the security right. While a registered security right cannot become effective against third parties until the requirements for creation are also satisfied, it ranks against competing security

rights from the time of registration, not the subsequent time of creation. As a result, the policy considerations addressed apply equally to situations where a notice is registered prior to the creation of a security right, and lapses before the security right is created, third party effectiveness may be re-established.

105. As noted, there are good policy reasons for both approaches. Nonetheless, because the efficient and effective functioning of a general security rights registry depends on the confidence that registrants and searchers have in its integrity, this Guide recommends that the first of the alternatives be adopted. If a registration lapses, or if third-party effectiveness lapses because one method for achieving it is no longer valid before another method is substituted, third-party effectiveness may be re-established, but it takes effect only from that time forward (see A/CN.9/631, recommendation 48).

B. Asset-specific remarks

1. Third-party effectiveness of a security right in a personal or property right securing payment of a receivable, negotiable instrument or any other intangible asset

106. Very often, receivables, negotiable instruments and other intangible assets are secured by a personal or property right (e.g. a personal guarantee or a security right). For example, a grantor in the business of selling goods on credit may have a security right in the goods to secure the buyers' payment obligations. Where the grantor is itself a lender, its customers' payment obligations may be backed up by a personal guarantee from a third party.

107. In most States, accessory personal or property security rights follow automatically the obligation payment of which they secure. That is, should the creditor of a receivable or holder of a negotiable instrument backed by one or more security rights transfer the receivable or negotiable instrument to a third party, the third-party transferee will also benefit from these security rights.

108. The idea that the accessory security rights follow the principal obligation (receivable, negotiable instrument) also generally applies to security rights that may be taken in the receivable or negotiable instrument. So, for example, because the accessory rights automatically follow the principal obligation, if the security right in the receivable or negotiable instrument has been made effective against third parties it should automatically extend to any accessory rights without the grantor or the secured creditor being required to undertake any further act. This result flows from general principles of the law of obligations in most States and is the approach recommended in this Guide (see A/CN.9/631, recommendation 49).

109. Additional policy considerations are present, however, if the personal or property right securing the principal obligation is an independent undertaking, and legal systems take different approaches in this case.

110. In some systems, these rights follow the payment obligation that they secure only if they are transferable and the transfer is made in a separate juridical act. This approach is based on the assumption that accessory rights are expected by parties to be transferred automatically with the obligations they secure but that the very fact of the independence of an independent undertaking means that parties would normally

have the contrary expectation. In other States, even independent security and other rights follow the obligation payment of which they secure automatically without a new act. This approach is based on the assumption that the secured creditor will normally request the grantor to transfer all rights securing the grantor's receivable and that simplifying the achievement of that result will save time and cost and thus have a beneficial impact on the availability and the cost of credit.

111. This second approach is also based on the assumption that rights of third-party obligors of independent rights (such as an independent undertaking) may be protected through separate rules. For example, in the case of a security right in the proceeds of a right to payment under an independent undertaking, third-party effectiveness automatically extends to the proceeds under the independent undertaking (i.e. the right to receive payment; see A/CN.9/631/Add.1, para. 19), but does not extend to the right to draw, which is an independent right (recommendation 26, subparagraph (b)). Because of this protection of the obligor under an independent undertaking, there is no reason not to automatically extend the third-party effectiveness of the secured creditor's rights to whatever rights it may claim in respect of the independent undertaking. This second approach is that adopted in this Guide (see A/CN.9/631, recommendation 49).

112. The case of an independent mortgage or hypothecation of an immovable raises other policy issues. In many States, a secured creditor that has made its security in a receivable effective against third parties will automatically be able to benefit from whatever normal mortgage or hypothecation on immovable property that secures the payment of the receivable. In some States, the law of immovable property requires that a notice of the security right be given to the grantor of the mortgage on the land. This Guide recommends automatic extension of the third-party effectiveness (see A/CN.9/631, recommendation 49), although it acknowledges that overriding policies in respect of land law may lead States to follow the second approach.

113. In some States, it is possible to transfer security rights in immovable property separately from the principal obligation that these rights secure. States that permit the creation of these types of independent mortgage do so primarily to facilitate the securitization and transfer of mortgages. Because the specialized financing practices associated with independent mortgages are typically carefully specified in the land law of a State, this Guide recommends that the automatic extension of third-party effectiveness to rights securing the payment of the receivable or negotiable instrument not apply where the right in question is an independent mortgage (see A/CN.9/631, recommendation 49).

2. Third-party effectiveness of a security right in a right to payment of funds credited to a bank account

114. Funds credited to a bank account are an increasingly important asset that grantors may offer as security for a loan or credit. The asset over which security is taken is not, in fact, the bank account itself, but rather the grantor's right to payment of funds credited to the bank account (for the definition of this term, see A/CN.9/631/Add.1, para. 19). States take different approaches to the requirements for third-party effectiveness of a security right in this type of asset. Among States that have not established a comprehensive security rights registry, most simply apply the general rules for achieving third-party effectiveness of security rights in receivables. This usually means registering a notice in a special registry devoted to

the assignment of or creation of a security right in receivables, although it may also sometimes involve the secured creditor giving written notice of the security right to the holder of the account. A similar approach, that is, considering the bank to be the debtor of a receivable, is also taken by many States that have established a comprehensive security rights registry. Because the funds in the bank account are not an identifiable species, the secured creditor can neither take possession itself, nor constitute the bank as its agent. Consequently, registration in the general security rights registry is the exclusive method for achieving third-party effectiveness.

115. Other States with general security rights registries have recently devised a specialized set of third-party effectiveness rules based on the assumption of “control” with respect to the account (for the definition of “control”, see A/CN.9/631/Add.1, para. 19). If the secured creditor is the depositary bank, control (and third-party effectiveness) is automatic. Other secured creditors can obtain control in either of two ways. One is for the secured creditor to replace the grantor as the bank’s customer on the account. While this creates the functional equivalent of the classic possessory pledge, it is impractical for the grantor’s checking and other current accounts to which it needs free access in the ordinary course of business. Consequently, the other variant, a “control agreement”, is the method mostly used in practice. Control is achieved through an agreement among the grantor, the secured creditor and the bank. As with automatic control by the depositary bank, a control agreement does not necessarily result in a blocking of the funds. Control (and therefore third-party effectiveness), is achieved even when the grantor remains free to draw on the account until notified otherwise.

116. Under both general approaches (e.g. treating the right to payment of the account as a receivable in respect of which third-party effectiveness of a security right can be achieved only through registration in the general security rights registry, or permitting third-party effectiveness to be achieved by means of a control agreement without the need for registration), a transferee of funds from a bank account under a transfer initiated by the grantor in the ordinary course of business takes free of the security right (see A/CN.9/631, recommendation 103). Otherwise, the two approaches have quite different priority consequences. Under the first approach, priority as a general rule turns on the order of registration of the security rights. The depositary bank does not enjoy any special priority status in its capacity as a secured creditor (although it typically has a right under other law to set off any claims it has against the grantor against a demand for payment by a prior ranking secured creditor and this normally means that it has a *de facto* priority). Under the second approach, a depositary bank with automatic control has priority over other secured creditors, except one that achieves control by replacing the grantor as the bank’s customer on the account (see A/CN.9/631, recommendation 101).

117. The first approach ensures transparency through public registration and permits the grantor to create a security right without the consent of the depositary bank. The second approach is more in line with banking practice. Automatic control in favour of the depositary bank is analogous to the law of set-off, which permits a depositary bank to apply funds credited to its customer’s account and therefore owing to the grantor against any amounts the customer owes the bank as a result of an extension of credit to the customer. However, the bank’s right of set-off for future loans is usually defeated once it receives notice of the creation of a security right

(or assignment) in favour of a third party. This may create difficulties for depositary banks and their commercial customers that often must be in position to act very quickly in bank account-related financing transactions. The need to ensure that no notice of a third-party assignment or security right has been received before acting on the customer's instructions may interfere with the efficiency of these transactions. Uncertainties about the precise timing of the receipt of notice and the bank's extension of credit may also invite litigation between a third-party secured creditor or assignee and the bank. The concept of automatic control, combined with the priority awarded to the depositary bank, eliminates this source of risk and uncertainty.

118. The approach that permits third-party effectiveness to be achieved through "control" with respect to the account does not have any adverse effects on the grantor. In the first place, the grantor must consent to the creation of a security right in favour of the depositary bank. Presumably the grantor will withhold this consent if the bank is not a source of financing. In addition, the priority rules associated with control can be altered by a subordination agreement in those situations where it would be more appropriate to ensure that first priority is given to another secured creditor. In a competitive banking environment, banks will not unreasonably withhold their consent to subordination (or to the conclusion of a control agreement), since the grantor is always free to change its account to another institution.

119. As for the lack of transparency inherent in the concept of control, it does not put third parties in a more disadvantageous position than they already occupy. As noted above, a depositary bank generally has the right under other law to set-off any obligations owing to it by the grantor in preference to rights of the grantor's creditors, both secured and unsecured. Since set-off is not a security right, it is not subject to any public registration requirement. Nor is the bank obligated to disclose its rights of set-off to third parties. Thus, creditors in States that adopt the first approach cannot rely on a clean search of the registry since the bank may always assert a preference under its private right of set-off. Nor are transferees of funds paid out of the account on the instructions of the grantor prejudiced since, as noted above, they generally take free of the security under both approaches.

120. States that have adopted the concept of "control" as a method for achieving third-party effectiveness do not make it an exclusive method. In other words, in these States third-party effectiveness may be achieved either by registration or by control. As noted, however, there are strong incentives for a secured creditor to achieve third-party effectiveness by control. A secured creditor with control has priority over any secured creditor that merely registers, regardless of the respective order of occurrence of control and registration (see A/CN.9/631, recommendation 101). Registration does, however, ensure that the security right will be effective against the grantor's judgement creditors and insolvency administrator since the priority given to the secured creditor with control may be claimed only against other secured creditors, and not as against all competing claimants (see A/CN.9/631, recommendation 101). Because the second approach is more in conformity with banking practices and the usual expectations of banks and their commercial customers, this Guide recommends that in addition to registration in the general security rights register, "control" be accepted as a privileged method for achieving

third-party effectiveness over the right to payment of funds credited to a bank account (see A/CN.9/631, recommendation 50).

3. Third-party effectiveness of a security right in proceeds under an independent undertaking

121.As explained in chapter IV (see A/CN.9/631/Add.1, paras. ...), in many States, a security right may be created in proceeds under an independent undertaking (for the definition of the term, see A/CN.9/631/Add.1, para. 19), but not in the right to draw under an independent undertaking (see A/CN.9/631, recommendation 28). On the other hand, some States do not permit a security right to be taken even in the proceeds of an independent undertaking. However, even among States that take the position recommended in this Guide, the particular character of the specific asset leads States to adopt different policies as to methods for achieving third-party effectiveness.

122.In some States, such a security right may be made effective against third parties in more than one way. For example, while it is impossible for the secured creditor to take possession since the asset (the proceeds under an independent undertaking) cannot exist in corporeal form unless and until paid, the secured creditor may register a notice in the general security rights registry. Alternatively, in States that recognize the idea of “control” (for the definition of “control” with respect to a security right in proceeds under an independent undertaking, see A/CN.9/631/Add.1, para. 19) the secured creditor may automatically have control or enter into a control agreement depending on the circumstances.

123.In other States, “control” is the exclusive method recognized for achieving third-party effectiveness of a security right in a right to proceeds under an independent undertaking. Control and, therefore third-party effectiveness, exists automatically if the secured creditor is the issuer or other nominated person (for the definitions of these terms, see A/CN.9/631/Add.1, para. 19). If the secured creditor is a third party, control requires the issuer or other nominated person to acknowledge the secured creditor’s entitlement to receive the proceeds upon a proper draw by the beneficiary. Under this approach a secured creditor can obtain control and, therefore, third-party effectiveness only if the issuer consents to pay any properly drawn proceeds to the secured creditor. The consent of the issuer is necessary because the issuer needs to be assured that the presentation has been duly made and that the beneficiary has agreed to the secured creditor’s right to receive the proceeds. Otherwise, it might find itself liable to the beneficiary for breaching the terms and conditions of the undertaking by paying the proceeds to a secured creditor that does not have the right to receive the payment.

124.As noted, the very nature the right to proceeds under an independent undertaking makes it impractical to achieve third-party effectiveness by taking possession of the proceeds. However, a secured creditor might take possession of the instrument itself. While possession of the independent undertaking does not achieve third-party effectiveness, possession would give a practical level of protection to a secured creditor when the terms of the independent undertaking require the physical presentation of the independent undertaking to the issuer in order to make a draw. As the beneficiary could not make an effective draw without the secured creditor’s cooperation, a secured creditor in possession could protect

itself by requiring the beneficiary to obtain an acknowledgement that would achieve control before surrendering possession of the instrument.

125. The particular practices of the letter of credit and independent guarantee industry have an important bearing on the manner in which a security right may be created in rights arising from an independent undertaking and the very rights upon which security might be taken (see A/CN.9/631, recommendation 28). These same particular practices require special attention to the methods by which third-party effectiveness, and especially effectiveness as against the issuer and nominated person, may be achieved. In order to protect the issuer against potential liability for payment to a secured creditor when presentation may not have been duly made, or when conditions in the security agreement may disentitle the secured creditor from claiming payment once a draw has been properly made, this Guide recommends that control be the exclusive method by which a secured creditor may achieve third-party effectiveness (see A/CN.9/631, recommendation 51).

4. Third-party effectiveness of a security right in a negotiable document or the goods covered by a negotiable document

126. The central characteristic of a negotiable document (e.g. a bill of lading) is that it represents the goods that are covered by it (for the definition of “negotiable document”, see A/CN.9/631/Add.1, para. 19). Because the document is negotiable it has the quality of tangibility that permits its holder to claim possession of the rights it represents. Delivery of a properly endorsed negotiable document is also generally treated as effective to transfer rights to the goods represented by the document. For this reason, in most States, a security right in a negotiable document will normally also extend to the goods covered by the negotiable document. If the security right in the negotiable document is effective, the security right in the goods covered by the document is also effective (see A/CN.9/631, recommendation 53).

127. The tangible character of the negotiable document means that, where States have a general security rights registry, a security right in the document may be made effective against third parties either (i) by registration in the general security rights registry or (ii) by transfer of possession of the document to the secured creditor as long as the goods are covered by the document (see A/CN.9/631, recommendation 52).

128. While registration and possession are alternative means of achieving third-party effectiveness, they do not produce identical consequences. In most States, a secured creditor that takes possession of the document during the period that the goods are covered by it has priority over competing claimants such as buyers or other transferees, and secured creditors, including secured creditors that may have achieved third-party effectiveness through an earlier in time registration in the general security rights registry. This approach reflects and supports the need to preserve the negotiable character of the document in commercial practice and for this reason it is the approach recommended in this Guide (see A/CN.9/631, recommendation 107).

129. In practice, a secured creditor may have to relinquish possession of the document to enable the grantor to deal with the goods in the course of its business. Normally, this would result in the lapse of third-party effectiveness, unless the secured creditor had also achieved third-party effectiveness through registration. In many States, however, the creditor that has not registered a notice of its security

right may nonetheless benefit from a temporary period of automatic third-party effectiveness (e.g. fifteen or twenty days) following relinquishment of possession of the document to enable the grantor to sell, exchange, load or unload or otherwise deal with the goods covered by the negotiable document. This automatic third-party effectiveness is not conditional on the secured creditor once again achieving third-party effectiveness before the expiry of the period. This means that the security right is effective against third-party rights that arise during the temporary period even if the security right is not otherwise made effective against third parties before the expiry of the short period. This approach reflects the typically short-term nature of financing transactions based on goods represented by a negotiable document which usually involve financing under an international sale of goods between a manufacturer or primary producer in one State and a wholesale buyer in another State. In the usual course of events, the secured creditor in this type of transaction will have been paid before the expiry of the period and will never retake possession of the negotiable document (see A/CN.9/631, recommendation 54).

130. It is, however, important to note that in order for this automatic third-party effectiveness to exist, the security agreement must have been concluded (that is, the security right must be effective as between the parties). Consider the case where a security right has been created by oral agreement and a transfer of possession to the secured creditor. The transfer of possession is not simply a method for achieving third-party effectiveness. It is an essential element for the creation of a security right by oral agreement. However, where a security right is not created by a transfer of possession writing is necessary. Hence, should the secured creditor later relinquish possession temporarily, automatic third-party effectiveness will not result unless there is a writing sufficient to ensure that the security right continue to exist as between the parties.

[Note to the Commission: The Commission may wish to consider revising recommendation 14 to clarify that, if the secured creditor relinquishes possession of an encumbered asset in which a security right was created by oral agreement and transfer of possession, a written agreement is necessary for the security right to continue to exist.]

C. Recommendations

[Note to the Commission: The Commission may wish to note that, as document A/CN.9/631 includes a consolidated set of the recommendations of the draft legislative guide on secured transactions, the recommendations are not reproduced here. Once the recommendations are finalized, they will be reproduced at the end of each chapter.]

A/CN.9/631/Add.3 [Original: English]**Note by the Secretariat on recommendations of the UNCITRAL
draft Legislative Guide on Secured Transactions, submitted
to the Working Group on Security Interests at its twelfth session****ADDENDUM****CONTENTS**

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VI. The registry system

A. General remarks

1. Introduction

1. Certainty of rights in property is a central concern in most legal systems. Historically, actual possession was the basic way for establishing entitlements to movable or immovable property. Over time, as various subsidiary rights in land were developed, States developed other mechanisms for establishing and recording these rights. Some States relied on private record-keeping, for example, through the office of a notary, while other States developed public land-registry systems. These public registries typically recorded and indexed rights according to the geographic description of the immovable property in question.

2. The same concern preoccupied States when regulating rights in movable property. Again, physical possession of assets was deployed as an indicator of ownership, but, as the number of transactions involving a dissociation of ownership and possession of movable property increased (for example, leases, loans and sales with a reservation of title), States were obliged to develop other means for recording entitlement to movable property. Once again, some States relied on notaries to maintain such records. Other States developed public registry offices for rights in movable property.

3. The creation of security rights over movable property posed particular challenges. Because of the difficulty of recording and keeping track of these various security rights, given the mobility of movable property and its transformation over time, many States enacted prohibitions on the creation of non-possessory security rights. This meant that creditors that wished to acquire a security right in movable property belonging to a grantor were obliged to take physical possession of the property. In this way, possession could continue to play its traditional role. However, as the need for credit for businesses in particular expanded, and businesses came to generate and make use of intangible assets, States were obliged to develop other mechanisms for recording security rights. Many States ultimately came to rely on the concept of registration as the primary mechanism for recording security rights in movable property.

4. Hence the centrality of registry systems for modern regimes of secured transactions and the importance of their design for the function of an efficient system of security rights in movable property. Recognizing the importance of a registry system for ensuring predictability and transparency with respect to rights serving security purposes, this Guide offers several recommendations about the optimal design and operation of a registry system meant to achieve these goals. Indeed, the establishment and implementation of a general security rights registry is one of the key objectives of an effective and efficient secured transactions law (see A/CN.9/631, recommendation 1, subpara. (f)).

5. The design and operational features of a registry system will be largely driven by the purposes that States pursue in establishing the registry. Among States, there is no uniformity of purposes meant to be accomplished through a registry system. States may, for example, seek to record actual title to movable property; or they may use the registry to record and make public the details of all transactions relating to movable property. Some States establish registries of more limited scope and for more limited purposes.

6. The general security rights registry recommended in this Guide is a limited purpose registry that focuses on the recording of security rights in movable property. As such, the registration system has three main purposes. The first is to achieve third-party effectiveness of a security right. As noted in chapter V on the effectiveness of a security right against third parties (see A/CN.9/631/Add.2), registration of a notice in a general security rights registry is the most common method for achieving third-party effectiveness of a security right. Second, registration contributes to efficient and fair priority ordering by establishing an objectively verifiable temporal reference for applying priority rules based on the time of registration. Third, registration provides third parties with an objective source of information about whether assets in the grantor's possession or control may be subject to a security right.

7. Given the other purposes that are often pursued through registration systems, it is important to note two fundamental features of the type of general security rights registry recommended in this Guide. To begin with, registration does not by itself result in third-party effectiveness. Third-party effectiveness is acquired only when there is a coincidence of registration and satisfaction of the requirements for creation set out in chapter IV (see A/CN.9/631, recommendations 12-14). This is significant, since registration of a notice may take place before a security agreement is concluded or a security right comes into existence (see A/CN.9/631, recommendation 65). In addition, registration does not give constructive notice of the existence of a security right. The doctrine of constructive notice is relevant only in a priority regime that allows a third party that does not have notice of a security right to take free of that security right. However, under the Guide, knowledge on the part of a competing claimant is irrelevant for determining priority (see A/CN.9/631, recommendation 75). Priority is based simply on the act of registration (or other third-party effectiveness act) regardless of whether the competing claimant knows or should know that the registration (or another act) has occurred. Conversely, a security right that has not been registered (or otherwise made effective against third parties) is ineffective against competing claimants regardless of their actual or presumed knowledge of the creation of the security right.

8. There are, as noted, many different models for implementing a registry system. The specific features of these different models are reviewed in the various sections of this chapter. Accordingly, in section A.2, this chapter addresses a number of considerations about the structure and operation of a general security rights registry. In sections A.3 and A.4, issues relating to the security, integrity and reliability of records in the registry are reviewed. Sections A.5 through A.8 discuss the required content of notices that may be filed in the registry. A number of details touching on the duration, time of effectiveness, amendment and cancellation of registration are considered in sections A.9 through A.13. The question of where registration should be made in transactions having a cross-border element is dealt with in chapter XIII on private international law (see A/CN.9/631/Add.10). Section B of this chapter contains a series of specific recommendations about the design and operation of the registry system meant to ensure that registration and searching processes are simple, efficient and accessible.

2. Operational framework

(a) General

9. The establishment of a registry system for security rights in movable property such as the one recommended in this Guide may constitute a significant change for many legal systems. Some States do not now have registries for security rights in movable property. Some States have movable property registries that record title, such as ship, aircraft or motor vehicle registries. Other States have multiple movable property registries depending on the type of asset, the type of grantor or the type of creditor. Some States may have a single registry, but require that the specific documents creating the security right be registered. Hence the importance of reviewing the various operational issues that must be considered in establishing an efficient registry for security rights in movable property.

(b) Public education and training

10. The critical importance of implementing an efficient and effective registry system for security rights in movable property suggests an important preliminary consideration. States must take steps to ensure that the business and legal communities are educated about the existence and substantive role of registration well in advance of the entry into force of the law. It is equally essential to ensure that clear advice on the practical logistics of the registration and searching processes is provided to potential registry clients. Guidelines and practice tutorials should be prepared and widely disseminated (ideally, in both printed and electronic form) well in advance of the activation of the registry system and in-person information and training sessions should be conducted periodically. Although the relevant governmental authority will usually take the lead in ensuring that adequate public education and guidance takes place, the expertise of the legal and business communities can be enlisted in aid. These initiatives need not be overly burdensome in view of the availability of implementation models and published materials in States that already have enacted similar reforms.

(c) Types of registry system

11. Over the years, States have developed different types of registry system. One of the most common can be described as a title registration system. This type of registry system contemplates the registering of title, and encumbrances on title, to immovable property or to specific movable property, such as ships. A title registry functions as a source of positive information about the current state of title to specific assets. In order to protect the integrity of the title record, the registrant is generally required to register the actual title transfer or security documents or a certified summary of those documents after having tendered them for scrutiny by the registrar.

12. A number of States have established what may be called a document registration system that, while not recording title to movable property, serves to evidence the existence of particular security devices. Sometimes, States have multiple registries of this type, depending on the asset, the grantor, the creditor or the type of security device deployed. Sometimes, States have consolidated security rights registers. Whether the registries are multiple or single, in these systems as well, the actual security documentation is submitted to and checked by a registrar who then issues a registration certificate that constitutes at least presumptive (if not conclusive) evidence of the existence of the security right.

13. In contrast to these systems, some States have adopted the concept of notice registration. In a notice registration system, the registry is not a source of specific information about the security agreement between the parties. Rather, the registry serves as a basis for achieving third-party effectiveness and priority. For this reason, there is no requirement to register the underlying security documentation or even to tender it for scrutiny by the registrar (and thus registration of a notice is not a requirement for the creation of a security right; see A/CN.9/631/Add.1, paras. 144 and 145). Registration is simply effectuated by registering a notice that provides only the identities of the parties, a sufficient description of the encumbered assets and, depending on the policy of each State, the maximum sum for which the security is granted.

14. Such a notice registration system greatly simplifies the registration process and minimizes the administrative and archival burden on the registry system.

For example, because it is not necessary to register specific documents, it is much easier to establish an electronic registry system, which is more time- and cost-efficient than a paper system. In addition, for the same reason, a notice registration system enhances flexibility with respect to the scope of the assets that may be encumbered (including after-acquired assets) and the obligations that may be secured (including future and fluctuating obligations). Moreover, registration is not meant to provide positive assurances about the existence of security rights. The objective is to alert third parties about the possible existence of such rights and to provide them with the information necessary to determine whether, in fact, such security rights exist. So, for example, prospective buyers and secured creditors can protect themselves by refusing to go ahead with the transaction unless the registration is cancelled or unless the secured creditor identified in the registered notice undertakes to subordinate its right to that of the prospective buyer or secured creditor. From the grantor's perspective, protection from unauthorized registrations can be achieved by requiring the grantor to be informed of any registration and by establishing a summary administrative procedure to facilitate the removal of unauthorized registrations (see A/CN.9/631, recommendations 56, subpara. (c), and 70). In any case, the benefit of any safeguards should be weighed against their cost.

15. Registries based on a notice-registration concept exist in many jurisdictions. Such registries have also attracted considerable international support (see the European Bank for Reconstruction and Development Model Law on Secured Transactions, the Organization of American States Model Inter-American Law on Secured Transactions, the *Guide to Movable Registries* of the Asian Development Bank, the Convention on International Interests in Mobile Equipment and its related protocols and the annex to the United Nations Convention on the Assignment of Receivables in International Trade).¹ Given the efficiency, accessibility and transparency of notice registration systems and the relative low cost of their operation, this Guide recommends that States adopt this model of a general security rights registry (see A/CN.9/631, recommendation 55).

(d) Prerequisites to registration

16. The formalities for and the prerequisites to registration vary from State to State. Most often these requirements depend on the type of registry system that is in place. For example, in some States the registered notice provides conclusive or presumptive evidence of a security right. Where this is the case, the registrar or some other public official has to scrutinize the contents of the document creating the security right, compare it with the notice and confirm the accuracy and effect of the notice. This adds to the cost and the time required for an effective registration. In addition, it is likely to increase the risk of error and liability of the registry.

17. In other States, as registration does not provide conclusive or even presumptive evidence of a security right, there is no need for official verification or scrutiny of the content of the notice or of its conformity with the document creating the security right. Adding a requirement for official verification or scrutiny in such cases would be inimical to the kind of efficient, speedy and inexpensive registration process needed to encourage access to secured credit. The basic idea is to permit registration without further formalities (e.g. affidavits and notarization of documents) as long as the required registration fees are paid and the required

¹ United Nations publication, Sales No. E.04.V.14.

information fields are completed regardless of their content (see A/CN.9/631, recommendation 55, subpara. (c)).

18. In addition, in States that adopt a notice registration system, there are typically no restrictions on who is permitted to make a registration. As registration serves to protect certain rights of the secured creditor, the registrant will normally be the secured creditor (the registrar may require the identity of the registrant but may not require verification; see A/CN.9/631, recommendations 55, subpara. (d), and 56, subpara. (b)). By contrast with States that require documents or a verified summary of documents to be registered in notice registration systems, consent by the grantor need not be established at the time of registration or be part of the information registered, since registration by itself does not create a security right. In order for the registration to be effective, the grantor has to consent to it but, once again, in notice registration systems the mere existence of the security agreement constitutes sufficient evidence of the grantor's consent to immediate registration unless, for example, the agreement specifically requires that the grantor give its consent in a separate document or at a later time (see A/CN.9/631, recommendation 55, subpara. (d)).

19. Because the prerequisites to registration in these systems are minimal, there is a risk of registrations relating to a non-existing or no longer existing security right. Should this occur, a summary administrative procedure is typically made available to the grantor to compel cancellation of an unauthorized or expired registration. Some States are concerned by potential fraud and abuse in these types of notice registration systems where registrations may be made with a minimum of formalities. In order to palliate this concern, States impose administrative penalties for unauthorized registrations or cancellations. However, the introduction of any safeguards depends on the judgement States make, following a cost-benefit analysis, about the additional complexity and expense that proscriptions of this nature are likely to impose (see A/CN.9/631, recommendations 70-73).

(e) Centralized and consolidated registry record

20. In many States, registry systems are both decentralized and multiple. For example, it is often the case that land registry offices are organized on a region-by-region, department-by-department or county-by-county basis. Some motor vehicle licensing registries are also decentralized in this way. In addition, in many States, there are multiple registries for security rights in movable property, depending on the type of asset (e.g. equipment, receivables or inventory), the grantor (e.g. a natural person, a corporation or an unincorporated business) or the nature of the security right (e.g. a floating charge, an enterprise mortgage, a retention-of-title transaction or a non-possessory pledge of stock). These types of registry tended to develop where the basis of the registration was title, or where States developed on a piecemeal basis different particular types of security rights in movable property.

21. Where States have come to adopt a functional concept of a security right in movable property there is a strong incentive to both centralize and consolidate the registry system. That is, once the substantive rules governing security rights are brought together under a uniform regulatory regime, it is most efficient to consolidate all registrations in a single registry record, regardless of the type of the security device, the nature of the grantor as a legal or a natural person, or the nature of the encumbered assets. In addition, even among States that maintain a formal diversity of acquisition financing rights (what this Guide calls a non-unitary

approach to acquisition financing rights, see chapter XII; A/CN.9/631/Add.9) many require the registration of these multiple acquisition financing rights in the general security rights registry. The development of consolidated registries also facilitates the establishment of a single centralized registry covering the entire State. Ideally, the record should be maintained in electronic form in a single centralized database for each country. In States in which separate regional or district records are maintained, complex rules are needed to determine the appropriate registration venue and to deal with the consequences of a relocation of the assets or the grantor. While it is possible to imagine the integration of decentralized, plural registries, the goals of efficiency, accessibility and transparency in the registration system are more fully achieved through consolidation and centralization of an electronic-form registry of the type recommended in this Guide (see A/CN.9/631, recommendation 55, subpara. (e)).

22. In many existing registry systems, the recording of notices is undertaken manually and the registry is itself paper based. Hence, States may have a legitimate concern about equality of access for users in remote locations. However, modern communication technology supports the rapid onward transmission of notices submitted to a branch office to the central registry. That is, by establishing records in electronic form, it is possible to use local registry offices as points of access to a centrally maintained registry. This is why many States have adopted electronic registries. In addition, electronic registries make it possible to establish mechanisms for online access to the record. As long as appropriate protocols for registration and searching are in place, this means that access to the registry will be possible from any location where Internet connections are available. Finally, even if the registry is maintained in electronic form, it is still possible to permit registration in paper form. In such cases, it is only necessary that information submitted in a paper form be transcribed into a computerized record with a name-based index. This manual transcription of data though, may increase the risk of error and liability of the registry. To the extent feasible, therefore, the registry should be designed so that those that wish to register notices have the responsibility for directly entering them electronically following an approved registration template.

(f) Public access

23. One of the central objectives of any registry system is to enhance certainty about entitlements to property. Ultimately, this is the underlying rationale for a security rights registry. A well-functioning registry enables actual and potential competing claimants (for the definition of “competing claimant”, see A/CN.9/631, Introduction, sect. B, Terminology and rules of interpretation, para. 19) to find out whether a security right has been or may be created in the grantor’s assets. With this information, they can take steps to protect themselves against the priority risk this poses to their potential rights or the impact that any given security right may have on their existing rights.

24. In order to achieve this objective, a registry record must normally be accessible by the public. States take different views about the balance to be achieved between protecting the confidentiality of parties to a security agreement (both grantors and secured creditors) and providing information to third parties about rights and encumbrances that may be claimed in the grantor’s property. The policy choices relate to three issues: (a) who is entitled to search the registry; (b) what criteria may be used to search the registry; and (c) how the registry is organized. These issues are considered in turn below.

(g) Prerequisites to searching

25. The many approaches to deciding who is entitled to search the registry can be reduced to two main types. Some States explicitly regulate who is entitled to search the registry in order to preserve the confidentiality or privacy of the parties' financial affairs. Access to the registry record for searching is restricted to persons that can demonstrate a "legitimate" reason. What constitutes a legitimate reason varies widely from State to State and sometimes the criteria are so narrowly drawn that open competition for credit can be compromised. In addition, the imposition of criteria for access implies that some person has to exercise judgement as to the "legitimacy" of the search, a step that slows down and increases the administrative cost of conducting a search.

26. In other States, most often those that have adopted a notice-based registry system, a person seeking to search the registry need not demonstrate a legitimate interest or offer any reason for conducting the search. The overriding objective in these States is to ensure that actual and prospective competing claimants are able to access the relevant information easily and efficiently. In these States, there is no necessity to limit access to the registry in order to protect the confidentiality of the grantor's and secured creditor's relationship. Confidentiality is ensured by limiting the level of detail about their affairs that appears on the public record. That is, the notice typically indicates only the names of the parties and a description of the encumbered assets and does not identify either the terms of the security agreement or the amount of the credit that has been extended or is still owed. In order to avoid encumbering the registry system with unnecessary cost and delay where only minimal information is provided in the registry record, this Guide recommends that searchers should not be required to establish a "legitimate reason", or indeed any reason, for the use of the registry (see A/CN.9/631, recommendation 55, subpara. (g)).

(h) Searching by reference to the grantor or to the secured creditor

27. Concerns about confidentiality also raise the issue of whether the registry system should be organized to facilitate public searching against the name of the secured creditor as well as the grantor. In some States, searching in the registry record may be possible by the name of the secured creditor. In those States, it is considered that, while the function of the registry does not require the record to be organized to permit searching by the name of the secured creditor, such searching is not an illegitimate use of the record. It is also considered that, for internal administrative purposes, it is useful to build in this kind of technical search functionality as it facilitates the processing of volume amendments to registered notices in cases where the secured creditor changes its business name or merges with another financial institution.

28. In other States, searching by the name of the secured creditor is not possible. The concern is to avoid systematic searches to profile secured creditors and their business relationships. The quantity and content of notices filed by a particular financial institution or other creditor may have market value as a source of a competitor's customer lists or for companies seeking to market related financial or other products. The retrieval and sale of this kind of information is not relevant to the purpose of the registry, would violate reasonable commercial expectations and may even damage public trust in the system. For these reasons, the Guide recommends that notices be indexed and retrieved only by the name or other identifier of the grantor (see A/CN.9/631, recommendation 55, subpara. (h)).

29. In order to further address this concern, in some of those States, it is possible to mention in the registered notice the name of a trustee, agent or other representative of the secured creditor (as is commonly done in syndicated loan arrangements where only the lead bank or its nominee is identified as the secured creditor). This does not prejudice the rights of third parties so long as the person identified as the secured creditor on the notice is in fact authorized to act on behalf of the actual secured creditor in any communications or disputes connected to the security right to which the registration relates. This is the approach recommended in the Guide (see A/CN.9/631, recommendation 58, subpara. (a)).

(i) Grantor as compared to asset indexing

30. The primary interest of a competing claimant is to determine whether any particular asset of a grantor is encumbered. For this reason, modern registries are organized so that it is possible for searchers to access this information either by reference to the grantor, or to the asset itself. Historically, land registries were organized and indexed by reference to the asset, rather than by reference to the grantor. In some States, there are also specialized movable property registries organized on the basis of an asset-indexing system. Nonetheless, the majority of States that have created registries for security rights in movable property (whether these are multiple registries or consolidated registries, and even when they are document-filing registries) organize and index these registries by reference to the grantor of the security right.

31. In a notice-based regime, indexing is generally done by reference to the identity of the grantor. Grantor-based indexing greatly simplifies the registration process. Secured creditors can achieve third-party effectiveness of a security right even in all of a grantor's existing and future movable property through a single registration. They need not worry about updating the record every time the grantor acquires a new asset as long as the asset fits into the description in the notice. Given the recommendation in this Guide that States establish notice-based registries, it follows that the primary indexing mechanism for the general security rights registry should be tied to the identity of the grantor (see A/CN.9/631, recommendation 55, subpara. (h)).

32. Grantor-based indexing does, however, have one important drawback. If the encumbered assets become the object of unauthorized successive transfers, prospective secured creditors and buyers cannot protect themselves by conducting a search according to the name of the immediate apparent owner. Because the system is grantor-indexed, the search will not disclose a security right granted by any predecessor in title. For example, the grantor sells the encumbered assets to a third party that, in turn, proposes to sell or grant a security right in them to a fourth party. Assuming the fourth party is unaware that the third party acquired the asset from the original grantor, the fourth party will search the registry using only the third party's name. Because the search will not disclose the registered security right, in order to discover the full picture of security rights that may affect the grantor's assets, the secured creditor will have to determine the chain of title to these assets. In order to do so, it will be necessary for the secured creditor to undertake this inquiry without the aid of the registry, since in almost all cases, there will be neither a record of the chain of title nor an indexing system that permits searching by reference to the asset.

33. Many States do, however, also have specialized title registries for certain categories of movable property (e.g. ships, aircraft and motor vehicles) in addition

to general security rights registries. In some of these registries, it is possible to register security rights as well as title. Where such registries are in operation the problem of hidden security rights granted by a predecessor in title does not exist, since a specific description or even a serial number is registered in the appropriate field where possible.

34. Serial number identification is, nonetheless, not without its drawbacks, especially where serially numbered property is held as inventory. Where serially numbered property constitutes either capital equipment or consumer goods (for the definition of “consumer goods”, see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation, para. 19) in the hands of the grantor it is usually treated as discrete by both the grantor and the secured creditor. However, if the encumbered assets are instead held by the grantor as inventory intended for resale, requiring a serial number description would impose an unworkable registration burden on secured creditors, since they would have to register each time a new item is acquired by the grantor. In any event, serial number identification of inventory is normally unnecessary to protect buyers and lessees. Most often they will acquire the encumbered assets in the ordinary course of the grantor’s business, in which case they will take free of any security rights granted by the inventory seller (see A/CN.9/631, recommendations 86-88). In addition, requiring serial number registration for items held as inventory limits the ability of a secured creditor to achieve third-party effectiveness of a security right in after-acquired serially numbered property through a single registration. In such a case, because the registered notice would have to include the serial number, the secured creditor would be required to file an amendment to the notice adding the new serial number as the grantor acquires each additional item. For these reasons, States that either deploy a title registry as a mechanism for recording security rights in that type of property, or provide for a serial-number field in the record of a notice-filing system, should limit the mandatory requirement for serial number identification to cases where the serially numbered property is not held as inventory.

[Note to the Commission: The Commission may wish to reflect in a recommendation the rule reflected in the last sentence of paragraph 34.]

(j) Registration and searching fees

35. The fundamental logic of a general security rights registry system is to enhance transparency and certainty regarding security rights (“security right” is defined by reference to movable property; see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation, para. 19). For this reason, modern registry systems are designed so as to encourage parties to use the registry to record security rights and to search for any pre-existing security rights. It is critical to the success of the registry system in enhancing access to secured credit at a reasonable cost, for fees to be set at a level that facilitates access, while still enabling the system to recover its capital and operational costs within a reasonable time period. Excessive registration and searching fees, designed to raise revenue rather than support the cost of the system, are tantamount to a tax on borrowers that simply reduces the availability and increases the cost of credit. Consequently, this Guide recommends that fees for using the registry should be no greater than what is required for the registry to be self-financing (see A/CN.9/631, recommendation 55, subpara. (i)).

(k) Modes of access to the registry

36. Until the end of the twentieth century, registration records had to be kept in paper form. Increasingly, however, even in States that require transactional documents to be filed, these records are being archived in electronic form. Similarly, while some States with notice-based registries still permit or require registration requests to be made in paper form, most of them provide for archiving these records in electronic form. In other words, the advent of digital storage has facilitated conversion of the registry record to a computerized record, greatly reducing the administrative burden on the registry.

37. A computerized record has many advantages over a paper-based system. Archives take less space and are easier to search. Most modern systems authorize electronic submission of registrations and the electronic submission and retrieval of search requests and search results, thereby facilitating direct client access. In addition, most modern systems permit direct electronic access to amend or cancel a registration. This significantly reduces the costs of operation and maintenance of the system. It also enhances the efficiency of the registration process by putting direct control over the timing of registration into the hands of the secured creditor. In particular, direct electronic access eliminates any time lags between submission of a notice to the registrar and the actual entry of the information contained in the notice into the database.

38. In some States with notice-based registries, electronic access (either from a client's premises or from a branch office of the registry) is the only available mode of access for both registration and searching. Because the data to be registered are submitted in electronic form, no paper record is ever generated. A fully electronic system of this kind places the responsibility for accurate data entry directly on registrants. As a result, staffing and operational costs of the registry are minimized and the risk of registry personnel making an error in transcribing documents is eliminated. Other States with notice-based registries give clients the option of submitting a paper registration or search request in person or by fax or verbally by telephone. However, even in these States, electronic submission is by far the most prevalent mode of data submission, used in practice for more than 90 per cent of registrations. The Guide recommends that multiple modes of access be made available to registry clientele at least in the early stages of implementation to reassure users unfamiliar with the system (see A/CN.9/631, recommendation 55, subpara. (j)).

(l) Service hours

39. Recognizing the importance of public access, most States operate their registries according to a reliable and consistent schedule, coordinating opening hours with the needs of their clients. If the system supports direct electronic access, the days and hours of operation are not a practical concern. It can be accessible on a continuous basis. For this reason, this Guide recommends that the registry should be designed so as to be accessible continuously except for scheduled maintenance (see A/CN.9/631, recommendation 55, subpara. (k)).

(m) Optimal use of electronic technology

40. The benefits of a general security rights registry that supports a computerized registry record and direct electronic access have already been outlined. However, the extent of computerization that is possible may vary in different States depending

on the extent of start-up capital available, access to the right expertise, the level of computer literacy of potential users, the reliability of the local communications infrastructure and the probability that expected revenues will be sufficient to recover the capital costs of construction within a reasonable period. Perhaps not all States will be able to move immediately to a fully computerized registry. Nonetheless, even where States continue to use paper-based registries, the overall objective is the same: to make the registration and searching process as simple, transparent, efficient, inexpensive and accessible as possible. Accepting that the practical considerations just noted will affect how quickly States may proceed to implementation, this Guide recommends that, to the extent possible, a general security rights registry that is computerized and that permits direct electronic access should be preferred (see A/CN.9/631, recommendation 55, subpara. (l)).

3. Security and integrity of the registry record

(a) State responsibility for the system

41. Over the years, States have adopted different approaches to the management and operation of systems meant to provide information about entitlements to movable property. In some, the system is an entirely public system run either as a part of normal Government operations or as a publicly owned corporation. In other States, by contrast, a particular profession (e.g. notaries) is delegated responsibility for managing certain types of public record. With the sole exception of States where no public recording mechanism exists and informal, privately run record offices fill the gap, the pattern is to consider the registries as a public service.

42. This does not mean that the day-to-day operation of the registry will have to be provided by public officials. For example, in many States, these day-to-day operations may be delegated to a private entity. This normally ensures the efficient operation of the registry and avoids burdening the State with costs and liabilities. In order to give a public assurance of the reliability of the registry, a public authority retains the responsibility to ensure that the registry is operated in accordance with the appropriate legal framework (see A/CN.9/631, recommendation 56, subpara. (a)).

(b) Record of the identity of the registrant

43. In some States, the registry may require both the identity and verification of the identity of the registrant. The main reason for this approach is to ensure the legitimate use of the record. The disadvantage is that it is likely to increase the time and cost of registration, as well as the risk of error and liability. In other States, while the registry may require the registrant to state its identity, it may not require verification of the identity of the registrant for the purpose of registering a notice. This means that the registrant does not have to be the secured creditor. However, in order to deter unauthorized or malicious registrations, the registry will need to maintain an internal record of the identity of registrants and require adequate proof of identity for this purpose (as to the relevant rights of the grantor, see A/CN.9/631, recommendations 70-73). This need not pose an excessive administrative burden since the verification procedure can be built into the payment process. Moreover, since most registrants will be repeat users, a permanent secure access code can be assigned when the account with the registry is opened, eliminating the need to repeat the identification procedures for subsequent registrations. This is the

approach recommended in the Guide (see A/CN.9/631, recommendations 55, subpara. (d), and 56, subpara. (b)).

(c) Grantor's entitlement to a copy of the registered notice

44. Because a registration serves as a notice that the grantor may have created a security right in its assets in favour of a creditor, and therefore may affect the grantor's ability to receive further secured credit, most States provide that a grantor named in a registered notice is entitled to receive a copy of the registration, or of any amendments to the notice made by the secured creditor. This enables the grantor to verify the accuracy of the data on the notice and, in the case of inaccurate, unauthorized or malicious registrations, to exercise its rights to compel the amendment or cancellation of the registration (see A/CN.9/631, recommendations 70-73).

45. States differ as to who should bear the obligation to forward a copy of the registered notice to the grantor. In order to provide optimal protection against the risk of unauthorized registrations, some States place this burden on the registry system itself. In this way, when the registration is fraudulent the purported grantor will discover the fraud, a discovery unlikely to occur if the obligation to forward a copy of the notice were placed on the purported secured creditor. However, this advantage must be weighed against the additional costs and risks such a burden would impose on the registry system. In the absence of evidence that unauthorized registrations are posing a serious and substantial threat to the integrity of the system in a particular State, a cost-benefit analysis supports placing the obligation on the secured creditor. In cases where the registration is made in good faith and is accurate, requiring the secured creditor to forward a copy of the registered notice to the grantor need not be a condition of the effectiveness of the registration and could even complicate or delay such effectiveness. This is because such a failure in no way affects the rights of third parties that will consult the registry. For this reason, most States provide that the failure of the secured creditor to meet this obligation may result only in nominal administrative penalties and the award of damages for any harm to the grantor resulting from such failure. Given the general approach of this Guide to keep the administrative costs of the registry as low as possible, it recommends that responsibility for furnishing a copy of the notice to the grantor be placed upon the secured creditor (see A/CN.9/631, recommendation 56, subpara. (c)).

(d) Secured creditor's entitlement to a copy of changes to registration

46. In most States, a registered notice may be cancelled by the secured creditor or the grantor and amended by the secured creditor or sought to be amended by the grantor through summary judicial or administrative proceedings (see A/CN.9/631, recommendations 70 and 71). In order to enable the secured creditor to check the legitimacy of the cancellation or amendment, the registry is normally obligated promptly to forward a copy of any changes to a registered notice to the person identified as the secured creditor in the notice. This should not involve excessive cost or risk for the registry system, since an efficient mode of electronic communication (e.g. electronic mail) can be agreed to when the account of the registry with the secured creditor is initially opened. Moreover, if the system is electronic, it can be programmed to forward automatically a copy of any amendments to a specified electronic mail account without the need for any human intervention (see A/CN.9/631, recommendation 56, subpara. (d)).

(e) Prompt confirmation of registration

47. Before advancing funds under a security agreement, a secured creditor will typically expect to receive some assurance that its notice has been entered into the registry record and that the information has been accurately recorded. Modern electronic registries are designed to enable the registrant to obtain a printed or electronic record of the registration as soon as the data is entered. In a paper-based registry, there will inevitably be some time lag between the submission of the notice and confirmation that it has been entered into the record, but every effort should be made to reduce the delay to a minimum (see A/CN.9/631, recommendation 56, subpara. (e)).

(f) Data integrity and preservation

48. Any registry system, whether paper-based or electronic, is at risk of destruction through unforeseen events. Usually, it is very difficult to reconstruct a paper-based registry if the physical records are damaged or destroyed (e.g. by flood or fire). Not many States have the resources to be able to keep duplicate papers archived at a separate location. Moreover, because these copies must be filed and indexed manually, there is an ever-present risk of error. Where a paper registry is archived electronically, however, or where the entire registry is itself kept electronically, it is much easier to ensure the preservation of data in the registry. States with electronic registries typically maintain a backup copy of the records of the registry on a separate server in a different location. This backup copy is normally updated by a separate procedure on a nightly basis so that it can be reconstructed in the event of system malfunction or physical destruction. In order to ensure that the integrity of the registry can be preserved in a cost-effective manner, this Guide recommends that electronic registries be systematically backed up (see A/CN.9/631, recommendation 56, subpara. (f)).

4. Responsibility for loss or damage

49. As noted above, a general security rights registry system is publicly administered in the sense that, while the maintenance of the system may be contracted out to the private sector, the ultimate supervisory responsibility is vested in a publicly appointed registrar and public servants under the registrar's supervision. For this reason, most States have detailed rules setting out the conditions under which they assume legal responsibility for loss or damage caused by staff or system errors and the extent of responsibility they are prepared to assume. In theory, staff or system error could cause loss in three situations.

50. The first situation, which may arise in the context of all types of registry (e.g. document registries, title registries, notice registries, paper-based registries or electronic registries), is where an employee or representative of the registry is alleged to have given incorrect or misleading verbal advice or information. Some States exclude liability altogether in this situation. In States where recourse against the registry is permitted in such cases, strict qualifications and limitations often apply. For example, in some States, the alleged victim must establish bad faith. In other States, the employee's conduct has to satisfy the standard of liability imposed by the general law governing fault-based obligations.

51. The second potential area of liability is for loss caused by an error or omission in the information entered into the record of the registry. Here, a first distinction must be drawn between notice registries and document registries. In the former

case, any substantive errors will be the responsibility of the person submitting the document for registration. The only error that can occur on the part of the registrar is if the identifying data on the document is incorrectly transcribed into the index. A further distinction must be drawn between paper and electronic registrations. If the notice is submitted electronically, the registrant is responsible for entering the data on the notice directly into the registry database and thus bears the risk of any errors or omissions. Even if the problem could conceivably have been caused by a malfunction in the system, States typically exclude liability for the failure of the system to effect an electronic registration or failure to effect it correctly. The absence of a paper version of the registered notice makes an allegation of systemic malfunction impossible to prove.

52. If a paper notice is used, the registrant is likewise responsible for the correctness of the information entered on the notice. However, regimes usually give a remedy for loss or damage caused by a failure on the part of registry staff to enter the information contained on the paper notice into the registry database or by a failure to enter it accurately. The risk of human error in transposing and retrieving data can be significantly alleviated by establishing electronic editorial checks and ensuring the timely return to the client of a copy of the registered notice or search result.

53. If the error on the part of the registry staff consists in entering inaccurate information, the person normally entitled to compensation will be a third-party searcher that suffers loss as a result of reliance on the misleading information in the registered notice. The position is different if the error consists in the failure of the registry staff to enter the information on the paper notice into the system altogether. The Guide recommends that registration be treated as effective only upon entry of the registration data into the database so as to be searchable by third parties (see A/CN.9/631, recommendation 68). It follows that where a paper notice is never entered into the system, it never becomes legally effective and the person potentially suffering the loss will be the secured creditor whose security right was never legally made effective against third parties.

54. The third situation where loss might be caused is where the registry issues a search result that contains erroneous or incomplete information. In this situation, some States recognize liability for loss caused by an error or omission in a printed search result produced by the registry system. However, issues of proof preclude liability where the claimant alleges an error in a search result viewed electronically or printed at the client's own premises (see, for example, the Convention on International Interests in Mobile Equipment).

55. In the limited circumstances where liability is recognized, States typically also elaborate rules to govern the procedure for making and proving a claim, the prescription period for launching a claim, and whether the quantum of recovery is subject to an upper limit. In order to ensure that claims against the registry do not bankrupt the system, States usually also establish insurance regimes to cover any loss. Where insurance is privately provided, a small amount is added to the registration fee in order to cover the insurance premium. Where the registry is self-insured, this additional amount is paid into a separate fund meant to cover payment of any successful liability claims (see A/CN.9/631, recommendation 57).

5. Required content of the notice

56. As noted, there are two approaches to registration. In some States, parties are obliged to file a copy of the security agreement. The result is that any person authorized to search the registry may obtain detailed information about the business relationship between the grantor and secured creditor. In other States, the registry simply records a notice about the potential security agreement and contains no other information. In most modern, notice-based registration systems, only the following basic information is required to be set out in the registered notice: the name or other identifier of the grantor and the secured creditor and their addresses, a description of the encumbered assets, and a statement of the duration of the registration. Each of these items of information is discussed in greater detail in the following sections of this chapter.

57. One point on which the approach among even those States which adopt a notice-registry system diverges is the question as to whether the notice must disclose the maximum monetary amount for which the security right covered by the notice may be enforced. In some States, it is not considered desirable to require either the actual amount of the initial secured obligation or a sum representing the maximum amount for which the security right may be exercised against the encumbered assets be set out. The concern is that this approach would (a) limit the amount of credit available from the initial secured creditor; (b) result in secured creditors inflating the amount of the secured obligation to cover future credit, which would inadvertently limit the ability of grantors to obtain credit from other sources; and (c) generally interfere with the ability of parties to secure future or fluctuating obligations (as in the case of revolving credit facilities).

58. However, many States require that the registered notice include a statement of the maximum amount to be secured by the security right. This approach is intended to facilitate the grantor's access to secured financing from later creditors in situations where the value of the assets encumbered by the prior registered security right exceeds the maximum amount indicated in the notice. It is based on the assumption that the grantor may obtain credit from other sources, even though that credit will be secured with a security right with a lower priority status than the security right securing the initially provided credit. It is also based on the assumption that the grantor will have sufficient bargaining power to ensure that the first-registered secured creditor does not register an inflated maximum amount. In some of the States that follow this approach, the result is that the priority of the security right to which the notice relates over subsequent security rights is limited to the maximum amount set out in the notice. In other States, the maximum amount of the secured obligation has to be stated, since a security right cannot be created in future obligations. This Guide acknowledges that both approaches have merit and recommends that particular States adopt the approach that is most consistent with efficient practices then in use in the State in question (see A/CN.9/631, recommendation 58).

6. Grantor's identifier

(a) Effect of error in the grantor's identifier on the effectiveness of registration

59. As mentioned above, in a modern general security rights registry, notices are indexed and searched by reference to the grantor's identifier (see A/CN.9/631, recommendation 55, subpara. (h)). Consequently, a reference to the grantor's identifier in the notice is an essential component of a valid registration. The impact

of an error in the grantor's identifier on the legal effectiveness of a registered notice depends on the organizational logic of the particular registry system. Some electronic records are programmed to retrieve only exact matches between the identifier entered by the searcher and the identifiers in the database. In such systems, any error will render the notice irretrievable by searchers using the grantor's correct identifier. For this reason, the consequence of error is that the purported registration is null and produces no third-party effects.

60. However, in some States, a more sophisticated search algorithm is put in place. In these States, registry records are organized and indexed so as to enable a searcher that enters the correct identifier to retrieve notices in which the grantor's identifier is a close but not identical match to the correct identifier. Similarly, if the searcher were to enter an incorrect identifier, a correct identifier that is a close but not identical match would also be retrieved. Where States have adopted these more sophisticated search algorithms, the validity of many otherwise defective registrations would be preserved. The usual result is that the registration is deemed to be legally effective notwithstanding the error if a search using the correct identifier would still disclose the registered notice albeit as an inexact match (see A/CN.9/631, recommendation 59). This type of system works only if the search logic of the system is carefully designed to limit the number of "close matches" that the search turns up. If searchers entering the correct identifier are confronted with a search result that yields an excessive number of notices containing "close matches", the burden of the initial registrant's error would be unfairly shifted onto the searcher, who might then have to undertake a large number of additional inquiries to determine which if any of these "close matches" might refer to the grantor in question.

(b) Correct identifier for natural persons

61. As an error in the grantor's identifier may invalidate a registration, States usually take great care to establish clear legal rules on what constitutes a correct identifier. The grantor's name is the most common criterion. However, a State may not have a universal rule on what constitutes a natural person's correct legal name and the name used in everyday business or social life may differ from that which appears on the grantor's official documents. Moreover, name changes may have occurred since birth as a consequence of a change in marital status or other deliberate choice. Consequently, the regulations or administrative rules governing the operation of the registry usually need to provide explicit guidance on what official documentary sources of the grantor's name can be relied on by registrants and searchers.

62. What documents will be considered authoritative for this purpose depends on the availability and reliability of the official documents issued by each State. In order to accommodate grantors that do not possess the relevant first-order official document and grantors that are not residents or nationals of a particular State, it is necessary to provide a hierarchy of alternative references (see A/CN.9/631, recommendation 60). There is no universal formula for setting this hierarchy, since so much depends on the resources available in each State for providing reliable identifiers for natural persons. That said, the following paragraph illustrates how the approach recommended in this Guide might be implemented.

63. States would provide that the name of a grantor that is a natural person will be determined according to a hierarchy of references:

(a) If the grantor was born in the enacting State and the grantor's birth was registered with a Government agency, the name of the grantor is the name stated in the grantor's birth certificate;

(b) If the grantor was born in the enacting State but the grantor's birth was not registered, the name of the grantor is:

(i) The name stated in a passport issued to the grantor by the Government of the enacting State;

(ii) If the grantor does not have a passport, the name stated in a current social insurance or other national identity card issued to the grantor by the Government of the enacting State;

(iii) If the grantor does not have a current passport or national identity card, the name stated in a passport issued to the grantor by the Government of the State where the grantor habitually resides;

(c) If the grantor was not born in the enacting State but is a citizen of the enacting State, the name of the grantor is the name that appears in the grantor's certificate of citizenship;

(d) If the grantor was not born in the enacting State and is not a citizen, the name of the grantor is:

(i) The name stated in a current visa issued to the grantor by the Government of the enacting State;

(ii) If the grantor does not have a current visa, the name stated in a current passport issued to the grantor by the Government of the State where the grantor habitually resides;

(iii) If the grantor does not have a current visa or a current passport, the name stated in the birth certificate or equivalent document issued to the grantor by the Government agency responsible for the registration of births in the State where the grantor was born;

(e) In a case not falling within the preceding rules, the name of the grantor is the name stated in a current motor vehicle operator's licence or vehicle registration certificate or other official document issued to the grantor by the enacting State.

64. If a search reveals that more than one grantor shares the same name, the provision of the grantor's address will often resolve the identity issue for searchers. In States where many individuals share the same name, it may be useful to require supplementary information, such as the grantor's birth date. If a State has adopted a numerical identifier for its citizens, this can also be used, subject to the enacting State's privacy and security policies and subject to prescribing an alternative identifier for grantors that are non-nationals. However, if additional or supplementary identifiers are required, the law should explain the consequences to the validity of the registration of providing only one of them correctly.

(c) Correct identifier for legal persons

65. For corporate grantors and other legal persons, the grantor's identifier for the purposes of effective registration and searching is normally the name that appears in

the documents constituting the entity. This name can usually be verified by consulting the public record of corporate and commercial entities maintained by each State (see A/CN.9/631, recommendation 61). Problems with common identifiers are unlikely to occur, since business names generally have to be unique to be accepted by a company or commercial registry. If the information in this record and in the security rights registry is stored in electronic form, it may be possible to provide a common gateway to both databases to simplify the verification process. States with modern registries seek to facilitate speedy and efficient public access to these records by registrants and searchers.

(d) Distinction between natural and legal persons

66. A registrant will usually be required to indicate whether the grantor is an “individual” or a “natural person” on the one hand, or a “legal person” on the other hand. Although the terminology may vary, the basic dividing line is the same. Accurate designation is essential because the two categories of grantors are usually stored in separate searchable fields or books within the registry record. A search in the legal persons record will not disclose a security right registered against an individual grantor, and the converse is also true.

(e) Impact of a change of the grantor’s identifier on the effectiveness of registration

67. A subsequent change in the grantor’s name or other applicable identifier (for example, as a result of a merger, consolidation or other similar act in which the new company continues in business under a different name) raises problems for the discovery of previously registered notices. The grantor’s identifier is the principal search criterion and a search using the grantor’s new identifier will not disclose a security right registered against the old name.

68. In many legal systems, a secured creditor that fails to amend the registered notice to disclose the grantor’s new identifier before the expiry of a specified time period is subordinated to secured creditors and buyers that acquire rights in the encumbered assets before the amendment notice is registered. The secured creditor retains whatever priority it enjoyed against secured creditors and buyers whose rights arose prior to the change of name. This approach reflects the purpose of requiring disclosure: to protect third parties that might otherwise rely to their detriment on a “clean” search result made against the grantor’s new name. The secured creditor retains priority against secured creditors and buyers that acquire rights in the encumbered assets during the specified time period only if the registration is amended before the expiry of that period. In other words, the specified period gives only conditional protection against a loss of priority (see A/CN.9/631, recommendation 62).

(f) Impact of a transfer of an encumbered asset on the effectiveness of registration

69. As with a change in the original grantor’s identifier, after a transfer by the grantor of the encumbered assets, a search against the transferee’s name by third parties dealing with the encumbered assets in the hands of the transferee will not disclose a security right created by the transferor. Many States follow the approach taken to a change of name by the grantor. The secured creditor must register an amendment disclosing the transferee as a grantor within a specified time period after the transfer to preserve priority over secured creditors and buyers who acquire rights

in the encumbered assets after the transfer. If the amendment is not made within the specified time period, the secured creditor is subordinated to intervening secured creditors and buyers whose rights arise after the transfer and before the amendment is registered (see A/CN.9/631, recommendation 63).

7. Secured creditor's identifier

70. The name of the secured creditor is not an indexing criterion. Consequently, registration errors in relation to a secured creditor do not pose the same risk of misleading third-party searchers and would not lead to nullification of the notice. However, the notice typically includes the name and address of the secured creditor so that any third-party financier may contact a secured creditor on record and, with the grantor's consent, obtain information, for example, as to whether there is a security right in the grantor's assets, which assets are encumbered and any value left unencumbered. Reference to the name of the secured creditor in the notice also provides presumptive evidence that the secured creditor that later claims a priority based on the notice is in fact the person entitled to do so. In order to ensure confidentiality as to the identity of the grantor, many systems permit that the notice refer to a representative of the secured creditor (see A/CN.9/631, recommendation 58, subpara. (b)). The rules used for determining the correct name of a grantor can also be applied to secured creditors.

8. Description of assets covered by the notice

71. In theory, in a notice-registration system, there is no absolute necessity for the registration to identify the encumbered assets, as the mere notice indexed under the grantor's name is sufficient to warn third-party financiers about the possible existence of a security right. However, the absence of any description in the notice might limit the grantor's ability to sell or create a security right in assets that remain unencumbered. Prospective buyers and secured creditors would require some form of protection (for example, a release from the secured creditor) before entering into transactions involving any of the grantor's assets. The absence of a description would also diminish the information value of the registry for insolvency administrators and judgement creditors. For these reasons, the Guide recommends that a description of the encumbered assets be included in the registered notice (see A/CN.9/631, recommendation 58, subpara. (b)).

72. Although a description of the encumbered assets is required, there is no need for a specific item-by-item description. The information needs of searchers are sufficiently served by a generic description (e.g. all tangible assets or all receivables) or even an all encompassing description (e.g. all present and after-acquired movable property). Indeed, a generic description is necessary to ensure the efficient registration of a security right granted in after-acquired assets and in revolving categories of assets, such as inventory or receivables (see A/CN.9/631, recommendation 64).

9. Advance registration and one registration for multiple security rights

73. In a notice-registration system, the registered notice is independent from the security agreement. Notice registration thus removes any practical obstacle to advance registration and thus a notice of a security right may be made before or after the security agreement is made or the security right is created.

74. “Advance registration” serves several important purposes. As a security right is created in a particular asset only when the grantor owns or has rights in the asset, any other rule would require registration of a new notice each time the grantor acquired a new asset. Thus, this rule is necessary to facilitate financing involving after-acquired assets. Advance registration also enables a secured creditor to establish its priority ranking against other secured creditors under the general first-to-register priority rule. Furthermore, advance registration avoids the risk of nullification of the registration in cases where the underlying security agreement was technically deficient at the point of registration but is later rectified, or where there are factual uncertainties as to the precise time when the security agreement was concluded.

75. A notice-registration system also removes any practical necessity for a one-to-one relationship between the registration and the security agreement. Consequently, the registration of a single notice is normally sufficient to achieve the third-party effectiveness of security rights in the assets described in the notice whether created under a single agreement or multiple unrelated agreements between the same parties (even if concluded at different times).

10. Duration and extension of the registration of a notice

76. The duration of secured financing relationships can vary considerably. The necessary flexibility can usually be accommodated in one of two ways. The first is to allow registrants to self-select the desired term of the registration with the right to register further extensions as appropriate. The second is for the system to set a universal fixed term (for example five years), also accompanied by a right to register extensions that will then take effect automatically for additional equivalent terms. In either case, extension of the registration is effected through a notice of amendment submitted to the registry before expiry of the effectiveness of the notice (see A/CN.9/631, recommendation 67).

77. In medium- and long-term financing arrangements, the first approach lessens the risk for secured creditors of a loss of priority for an inadvertent failure to register an extension in time. In short-term financing arrangements, the second approach reduces the risk for grantors that secured creditors will register for an inflated term out of an excess of caution. In order to encourage timely cancellation in systems that adopt the second approach, a State may choose to not charge any fee for registration of a cancellation. Furthermore, in order to discourage the selection of excessive registration terms, fees can be based on an incremental tariff related to the length of the registration life selected.

11. Time of effectiveness of registration of a notice or amendment

78. As a general rule, priority between competing security rights that have been made effective against third parties only by registration depends on the order of registration (see A/CN.9/631, recommendation 78, subpara. (a)). It follows that the time at which a registration became legally effective is vital in determining priority among competing security rights. If the security right is already in existence, the time at which a registration takes legal effect may also be critical to the resolution of competing rights between a secured creditor and a buyer or lessee of the encumbered asset, or the grantor’s unsecured creditors and insolvency representative.

79. In a registry system that permits the submission of paper notices to the registry (as opposed to requiring direct electronic entry by registrants), there will inevitably be some delay between the time the notice is received in the office of the registry and the time the information on the notice is entered into the registry record by the registry staff so as to be searchable by third parties. This time lag raises the question of when registration should be considered legally effective: the time when the paper notice is received in the registry office or the time when the information on the notice becomes publicly searchable.

80. In resolving this issue, many legal systems place the priority risk created by a time lag on the secured creditor and not on third-party searchers. Consequently, the effective time of registration is concomitant with the ability of searchers to find the notice (see A/CN.9/631, recommendation 68). It would affect the reliability of the registry if searchers were to find themselves bound by a notice that was not publicly searchable. In any event, the secured creditor is in a better position to take steps to protect itself than third parties (for example, by withholding credit until the notice becomes searchable) and the design and operation of the registry should ensure speedy and efficient registration procedures that minimize delay.

81. In a fully electronic system that requires no intervention by registry staff, entry of the notice and its availability to searchers is virtually simultaneous and this problem is essentially eliminated.

12. Authority for registration

82. Normally, registration of a notice is not effective unless the grantor authorizes it in writing. However, in order to avoid delays, costs and errors, authorization is not required to be proven at the time of registration (see A/CN.9/631, recommendation 55, subpara. (d)). In any case, if there is no authorization, registration is not effective and the grantor may request its cancellation through summary judicial or administrative proceedings (while other law may provide for penalties for fraudulent registrations). Usually, authorization is given in the security agreement, expressly or implicitly (see A/CN.9/631, recommendation 69).

13. Cancellation or amendment of a registered notice

(a) Compulsory cancellation or amendment

83. For reasons of security, many legal systems provide that only the secured creditor has the authority to cancel or amend a registration. However, an unauthorized registration can have a prejudicial impact on the ability of the person named as grantor in the notice to sell or create a security right in the assets described in the notice. It is, therefore, essential to ensure that registered notices are cancelled or amended promptly if no security agreement exists or is contemplated, or if the security right has been extinguished by full and final satisfaction of the secured obligation or if a registered notice contains information not authorized by the grantor (for example, the asset description contained in the notice may be overly broad, including items or kinds of assets that are not intended to be the object of any actual or contemplated security agreement between the parties).

84. To address this need, many legal systems provide that the grantor has the right to send a written demand to the secured creditor to discharge or amend the registration to reflect the actual status of their relationship. The secured creditor is obliged to register a notice of cancellation or amendment, as the case may be, within

a specified time period (for example, 20 or 30 days) after receipt of the demand. If the secured creditor fails to comply, the grantor is then entitled to compel cancellation or amendment of the notice through a summary judicial or administrative procedure (see A/CN.9/631, recommendations 70 and 71). In some States, unless the secured creditor obtains a contrary court order, non-compliance entitles the grantor to require the registrar to register the discharge or amendment on proof to the registrar that the demand was made and not satisfied and after notice to the secured creditor.

(b) Expunging and archiving of cancelled notices

85. Once a registered notice has expired or been cancelled, it is normally promptly removed from the publicly searchable records of the registry (the secured creditor is obliged to take this action; see A/CN.9/631, recommendation 109, subpara. (b)). However, the information provided in the expired or cancelled notice and the fact of expiration or cancellation is archived so as to be capable of retrieval in the future if necessary (see A/CN.9/631, recommendation 72).

(c) Amendments

86. As mentioned above, an amendment to disclose a subsequent change in the identifier of the grantor (whether as a result of a change of name or a transfer of the encumbered assets) is necessary to preserve priority against subsequent secured creditors and buyers. In contrast, legal systems provide that a secured creditor is entitled, but not obliged, to amend a registered notice where the identity of the secured creditor changes as a result of an assignment of the secured obligation. Registration of an amendment notice is in this case optional, since a change in the identity of the secured creditor, unlike a change in the identity of the grantor, does not affect the ability of third-party searchers to retrieve the notice. Consequently, the registered notice retains its legal effectiveness whether or not the amendment is made.

87. Although it is optional, registration of a notice about an assignment is prudent. Failure to register leaves the assignor as the secured creditor of record, exposing the assignee to the risk that it will not receive notices sent by third parties and leaves the assignor with the legal power to alter the state of the record, for example by registering a notice of cancellation or other inappropriate amendment (see A/CN.9/631, recommendation 73).

88. The situation is different where the security right is not registered or otherwise made effective against third parties at the time of the assignment. Here, the assignee will need to register a notice in order to make the security right effective against third parties. There is no reason why the notice may not name the transferee as the secured creditor. There should be no need, in other words, to first register in the name of the original secured creditor.

89. If the grantor's financing needs change after the conclusion of the original security agreement, the grantor may agree to create a security right in additional assets. In the interest of flexibility, the registry system may allow the description in the registered notice to be amended to add the newly encumbered assets rather than requiring a new notice to be registered. However, the amendment is effective with respect to the newly encumbered assets only from the date it is registered, with the result that it cannot prejudice third-party rights acquired in the additional assets prior to registration of the amendment.

90. The situation is different when the amendment reflects new assets in the form of proceeds of the original encumbered assets. If the amendment is made before the expiry of the applicable period of temporary automatic third-party effectiveness, the security right in the proceeds takes effect against third parties as of the date of registration of the original notice.

91. If the description in the original registration covers after-acquired assets, there is normally no need to amend the registration. However, if the system adopts supplementary asset registration for after-acquired serially numbered goods, it will be necessary to amend the registration to include the new serial numbers in order for the security right to take effect against third parties.

92. Where a secured creditor agrees to subordinate or postpone a registered security right to the right of another creditor, registration of an amendment to disclose the subordination in principle should not be required or should be optional, since the subordination only affects the priority position of the relevant parties as against each other.

B. Recommendations

[Note to the Commission: The Commission may wish to note that, as document A/CN.9/631 includes a consolidated set of the recommendations of the draft legislative guide on secured transactions, the recommendations are not reproduced here. Once the recommendations are finalized, they will be reproduced at the end of each chapter.]

A/CN.9/631/Add.4 [Original: English]

**Note by the Secretariat on recommendations of the UNCITRAL
draft Legislative Guide on Secured Transactions, submitted to the
Working Group on Security Interests at its twelfth session**

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VII. Priority of a security right as against the rights of competing claimants

A. General remarks

1. The concept of priority and its importance

1. In a secured transactions regime, the term “priority” refers to the extent to which a secured or other creditor may derive the economic benefit of its right in an encumbered asset in preference to a competing claimant (for the definitions of the terms “priority” and “competing claimant”, see Introduction, sect. B, Terminology and rules of interpretation, para. [...]). As discussed below, only one of the competing claimants must be a secured creditor of the grantor. Any other competing claimant may be another secured creditor of the grantor or the holder of another

type of proprietary right, such as the holder of a right created by statute (e.g. a preferential creditor) or by judgement (i.e. a judgement creditor), a buyer, lessee or licensee of the encumbered asset or the insolvency representative in the grantor's insolvency proceeding.

2. Issues of priority typically arise where the debtor defaults on a secured obligation and the value of the encumbered asset is not sufficient to satisfy that obligation as well as the obligations owed to other competing claimants asserting a right in the asset. In these situations, the secured transactions law must determine how the economic value of the asset is to be allocated among competing claimants. A typical example of such a case is where a grantor defaults on a loan obligation to a lender that is secured by an asset of the grantor, and the grantor has also created a security right in the same asset in favour of another lender to secure a different loan. Another example is a situation where a grantor defaults on a loan obligation to a lender that is secured by an asset of the grantor, and an unsecured creditor of the grantor has obtained a judgement against the grantor and has taken steps under applicable law to obtain a property right in the same asset by reason of the judgement.

3. In other cases, the application of priority rules will lead to a person taking the encumbered asset free of competing claims. A typical example of such a case is where a grantor creates a security right in an encumbered asset in favour of a lender and then sells the asset to a third party. In this situation, the secured transactions law must determine whether the buyer of the asset takes title to the asset free of the lender's security right. Another example is where a grantor creates a security right in an encumbered asset in favour of a lender and then leases or licenses the asset to a third party. Here, the secured transactions law must determine whether the lessee or licensee may each enjoy its proprietary rights under the lease or license unaffected by the lender's security right.

4. An essential element of an effective secured transactions regime is that security rights have priority over the rights of unsecured creditors. It is generally accepted that giving secured creditors priority over unsecured creditors is necessary to promote the availability of secured credit. Unsecured creditors can take other steps to protect their rights, such as monitoring the status of the credit, charging interest on amounts that are past due or obtaining a judgement with respect to their claims in the event of non-payment. In addition, secured credit can increase the working capital of the grantor, which in many instances benefits the unsecured creditors by increasing the likelihood that the unsecured debt will be repaid. In fact, advances made under a secured revolving working capital loan facility are often the source from which a company will pay its unsecured creditors in the ordinary course of its business (see chap. II, Scope of application and other general rules, sect. F, Examples of financing practices covered, paras. [...]).

5. However, in all the cases mentioned above, priority is an issue only if security rights are effective against third parties. Security rights that are not effective against third parties have the same ranking as against each other and as against the rights of competing claimants (including unsecured creditors). However, security rights that are not effective against third parties are nevertheless effective against the grantor (see A/CN.9/631, recommendation 31).

6. The concept of priority is at the core of every successful secured transactions regime and it is widely recognized that effective priority rules are necessary to

promote the availability of secured credit. There are two primary reasons for this. First (as discussed in para. 7 below), to the extent that priority rules are clear and lead to predictable outcomes, prospective secured creditors are able to determine, in an efficient manner and with a high degree of certainty prior to extending credit, the priority that their security rights will have relative to the rights of competing claimants in the event that a priority dispute arises in the future. Thus, priority rules function not only to resolve disputes, but also to encourage prospective creditors to extend credit by allowing them to predict how a potential priority dispute will be resolved. In this way, the existence of effective priority rules can have a positive impact on the availability and cost of secured credit. Second (as discussed in para. 8 below), where the secured transactions regime recognizes the ability of a grantor to create more than one security right in the same encumbered asset, effective priority rules encourage prospective creditors to extend credit secured by the excess value of an asset already subject to a security right in favour of other creditors, thereby making it possible for grantors to utilize the full value of their assets to obtain more credit, which is one of the key objectives of any effective and efficient secured transactions regime (see chap. I, Key objectives, sect. B).

7. With respect to the first reason mentioned above, the most critical issue for the secured creditor is what its priority will be in the event it seeks to enforce the security right either within or outside of the grantor's insolvency, especially where the encumbered asset is expected to be the creditor's primary or only source of repayment. To the extent that the creditor has uncertainty with respect to the priority of its prospective security right at the time it is evaluating whether to extend credit, the creditor will place less reliance on the encumbered asset. This uncertainty may cause the creditor to increase the cost or reduce the amount of the credit to reflect the diminished value of the encumbered asset to the creditor, and may even cause the creditor to refuse to extend credit altogether. To minimize this uncertainty, it is important that secured transactions laws include clear priority rules that lead to predictable outcomes and also that these outcomes are respected by insolvency law to the maximum extent possible (see chap. XI, Insolvency, paras. [...]).

8. With respect to the second reason mentioned above, it should be noted that priority rules have an additional positive impact on the availability of secured credit, since many banks and other financial institutions are willing to extend credit based upon security rights that do not have a first-priority ranking but are subordinate to one or more higher-priority ranking security rights, so long as they perceive that there is value in the grantor's assets to support their security rights and can clearly establish the lower-ranking priority of their security rights. For example, in jurisdictions that recognize an all-asset security (see chap. II, Scope of application and other general rules, sect. F, Examples of financing practices covered, paras. [...]), Lender B may be willing to extend credit to a grantor whose assets are already subject to an all-asset security in favour of Lender A, so long as Lender B believes that the value of the grantor's assets sufficiently exceeds the amount of the loan secured by the existing all-asset security to support the additional extension of credit by Lender B. This result is much more likely to occur in a jurisdiction that has clear priority rules that enable creditors to assess their priority with a high degree of certainty. By facilitating the granting of multiple security rights in the same assets, priority rules enable a grantor to maximize the extent to which it can use its assets to obtain credit.

9. Because of the importance of priority rules, a modern secured transactions regime typically incorporates a set of priority rules that are comprehensive in scope, covering a broad range of existing and future secured obligations and encumbered assets, and providing ways for resolving priority conflicts among a wide variety of competing claimants. Such rules also typically deal with the impact on priority of the method by which the security right is made effective against third parties (e.g. automatic third-party effectiveness, registration, possession or control). A secured transactions law that incorporates such precise and detailed priority rules, as opposed to a set of abstract principles that can require interpretation in particular cases, encourages prospective creditors to extend secured credit by giving them a high degree of assurance that they can predict how potential priority disputes will be resolved.

10. In view of the above, the Guide identifies a two-fold purpose of the priority provisions of a secured transactions law (see below, sect. C, Recommendations, Purpose).

11. It is important to note that no matter what priority rule is in effect in any jurisdiction, it will only have relevance to the extent that the applicable conflict-of-laws rules provide that such priority rule governs. This issue is discussed in chapter XIII, Conflict of laws (see paras. [...]).

2. Approaches to determining priority

12. There are various possible approaches to determining priority. More than one of these approaches may effectively coexist in the same legal system insofar as they may apply to different types of priority conflicts. This section describes these various approaches, indicating in each case their respective advantages and disadvantages in the context of a modern secured transactions regime.

(a) Priority rules where a registration system exists

13. As discussed above, in order to promote the availability of secured credit effectively, it is important to have priority rules that permit creditors to determine their priority with the highest degree of certainty at the time they extend credit and that enable grantors to use the full value of their assets to obtain credit. As discussed in chapter V, Effectiveness of a security right against third parties, (paras. [...]) and chap. VI, The registry system, (see paras. [...]), one of the most effective ways to provide for such certainty is to base priority on the use of a public registry.

14. In most jurisdictions in which there is a reliable system for registration of notices with respect to security rights, priority is determined by the order of registration of the notice, with priority being accorded to the right referred to in the earliest-registered notice (often referred to as the “first-to-register priority rule”). In some jurisdictions, this rule applies even if one or more of the requirements for the creation of a security right have not been satisfied at the time of the registration, which avoids the need for a creditor to search the registration system again after all remaining requirements for the creation of its security rights have been satisfied. This rule provides the creditor with certainty that, once it registers a notice of its security right, no other right with respect to which a notice is registered will have priority over its security right. Other existing or potential creditors are also

protected because the registered notice will warn them about potential security rights and they can then take steps to protect themselves (such as by requiring personal guarantees or security rights with lower-priority ranking in the same property or higher-priority-ranking security rights in other property).

15. Notwithstanding the foregoing, some States have recognized limited exceptions to the first-to-register priority rule. For example, a security right in consumer goods is deemed to be automatically effective against third parties upon its creation. Thus, the priority of such a security right is determined on the basis of the time of its creation.

16. In other States, as long as registration occurs within a specified period of time after the creation of a security right (often referred to as a “grace period”), priority will be determined according to the order of creation rather than registration of a notice with respect to the security right. Thus, a security right that is created first but registered second, may still have priority over a security right that is created second but registered first, as long as the notice is registered within the applicable grace period.

17. Under such an approach, because of the possibility that its registered security right will become subordinate to an earlier-created security right that is registered within the applicable grace period, a prospective secured creditor can protect itself only by delaying its extension of credit to the grantor until any applicable grace period relating to other potential claims has expired. Thus, until the grace period expires, the registration date is not a reliable measure of a creditor’s priority ranking and there is significant uncertainty that does not exist in legal systems in which no such grace periods exist.

18. In order to avoid undermining the certainty achieved by the first-to-register rule, some States restrict the use of grace periods to rare circumstances, such as: (a) acquisition security rights (unitary approach) or acquisition financing rights (non-unitary approach); (b) circumstances in which registration before, or concurrently with, creation is not logistically possible; or (c) circumstances in which the time difference between creation and registration cannot be minimized through the use of electronic registration or other registration techniques.

19. Many States have adopted an exception to the first-to-register priority rule for security rights in specific types of asset, such as cars and boats, which may also be registered in a specialized registry or noted on a title certificate. As a result, a security right registered in one of those systems is often given priority over a security right with respect to which a notice was previously registered in a general security rights registry. The reason for this approach is the need to ensure that purchasers of assets that are registered in a specialized registry or noted on a title certificate can have full confidence in the records of that system in assessing the quality of the title they are acquiring.

(b) Priority based on possession or control

20. As discussed in chapters IV, Creation of a security right (effectiveness as between the parties) (see paras. [...]) and V, Effectiveness of a security right against third parties (see paras. [...]), possessory security rights traditionally have been an important component of the secured transactions laws of most jurisdictions. In recognition of this fact, even in certain jurisdictions that have a first-to-register

priority rule, priority may also be established based on the date that the creditor obtained possession of the encumbered asset, without any requirement of a registration of a notice. In these jurisdictions, priority is often accorded to the creditor that first either registered a notice of its security right in the registration system or obtained a security right by possession.

21. Notwithstanding its importance, priority based on possession has significant disadvantages. First, it is usually commercially impractical in those situations where the grantor must maintain possession of the encumbered assets so as to use them in the operation of its business. Second, the requirement that the secured creditor maintain possession of the encumbered asset may impose undesirable administrative burdens on the creditor. Third, because possession often is not a public act, the holder of a security right made effective against third parties by possession will, under many legal regimes, have the burden of establishing precisely the time when it obtained possession.

22. Despite these disadvantages, priority based on possession is commercially useful in the case of certain types of encumbered asset, such as negotiable instruments (e.g. a cheque, bill of exchange or promissory note; see Introduction, sect. B, Terminology and rules of interpretation, para. [...]) or negotiable documents of title (e.g. a bill of lading or warehouse receipt; see Introduction, sect. B, Terminology and rules of interpretation, para. [...]), in which possession by the secured creditor can enable the creditor to prevent prohibited dispositions of the encumbered asset by the grantor. For these types of asset, the laws of many States provide that priority of a security right may be established either by possession or registration. In addition, a security right that becomes effective against third parties by possession is generally accorded priority over a security right made effective against third parties only by registration, even if the registration occurs first. This result is consistent with the expectations of the parties in the case of negotiable instruments and negotiable documents, because rights in such assets are traditionally transferred by possession.

23. In some States, the concept of possession has evolved into the more sophisticated concept of “control”, according to which a secured creditor may be deemed to have possession of an encumbered asset if it is able, by contract with the person holding actual possession of the asset, to control the disposition of the asset. In those States, control is recognized as a method of making a security right effective against third parties. In the case of certain types of asset, such as the proceeds under an independent undertaking, control may be the exclusive method for achieving effectiveness against third parties. In such a case, priority is accorded to a security right in such an asset only if the secured creditor is deemed to have control with respect to the asset. In the case of other types of asset, such as the right to the payment of funds credited to a bank account, third-party effectiveness may be based on either control or registration in the general security rights registry. Here, the priority system generally awards priority to a security right made effective by control over a security right made effective by an alternative method.

(c) Alternative priority rules

24. In jurisdictions in which there is no registration system for security rights, both effectiveness of a security right against third parties and priority are often based on the time when the security right is created. In those jurisdictions, although

non-possessory security rights may be permitted (often in the form of retention-of-title sales, transfers of title to tangible property or assignments of receivables for security purposes), creditors typically seek to ascertain the existence or non-existence of competing rights through representations by the grantor or information available in the market. In those jurisdictions, because there is no system to determine the priority of creditors with security rights in the same asset, it is difficult or impossible for a grantor to grant more than one security right in the same asset and thus to utilize fully the value of its assets to obtain secured credit. However, the secured obligation may be assigned (e.g. by the retention-of-title seller) together with the right securing it, but this approach often results in costs to the seller that are passed on to the end-buyer (in addition to the cost of the initial acquisition financing reflected in the price of the goods or the interest rate of the credit).

25. Some jurisdictions have adopted a special priority rule with respect to certain types of encumbered asset. For example, in some jurisdictions, effectiveness of a security right in a receivable against third parties and competing claims is based on the time that the debtor of the receivable is notified of the existence of the security right. However, this system is not conducive to the promotion of secured credit for a number of reasons. First, it does not permit the creditor to determine, with a sufficient degree of certainty at the time it extends credit, whether there are any competing security rights in the receivables. Second, the system does not provide an efficient way of obtaining security rights in future receivables because notification of the debtors of future receivables may not be possible at the time of the initial extension of credit and therefore debtors of the future receivables must be notified as the future receivables arise (except in the case of future receivables expected to arise under a long-term contract that exists at the time when credit is extended). Third, if there is a large number of debtors of receivables, notification may be costly. Fourth, many grantors may not wish to have their customers directly notified of the existence of a security right in their receivables.

3. Extent of priority

26. In order to encourage creditors to extend secured credit, it is essential that they be able to determine at the time they make a commitment to extend credit whether the priority of their security right will extend to the entire secured obligation owed to them or just to a portion of it. Specifically, they must be able to determine whether priority will extend only to the credit they extend contemporaneously with the conclusion of the security agreement or whether it will extend to: (a) obligations that arise thereafter pursuant to the terms of the security agreement (e.g. future advances under a revolving credit agreement); or (b) contingent obligations that become actual obligations thereafter upon the occurrence of the contingency (e.g. obligations that become payable under a guaranty).

27. In some jurisdictions, the same priority is accorded to the entire secured obligation, regardless of the time when the obligation arises. Under such an approach, a security right may extend to all secured monetary and non-monetary obligations owed to the secured creditor, including principal, costs, interest and fees. Priority is unaffected by the date on which an advance or other obligation secured by the security right is made or incurred. This means that a security right may secure

future advances under a credit facility with the same priority as advances made under the credit facility contemporaneously with the creation of the security right.

28. For example, in the case of a loan facility under which the lender has agreed on Day 1 to make advances to the grantor from time to time for the entire one-year term of the facility, secured by a security right in substantially all of the grantor's assets, the security right will have the same priority for all of the advances made, regardless of whether they are made on Days 1, 35, or 265.

29. In the case of credit extended for the delivery of goods or services in instalments matching deliveries of goods or services, this approach results in the entire claim being treated as coming into existence at the time when the contract is entered into and not at the time of each delivery of goods or services. The rationale for this approach is that it is the most cost-efficient approach (e.g. the secured creditor need not determine priority each time it extends credit) and minimizes the risk to the grantor that subsequent extensions of credit under the security agreement will be interrupted if the secured creditor determines that a future advance does not have priority.

30. In other jurisdictions, priority is limited in one of two ways. First, priority may be limited to the amount of debt existing at the time of the creation of a security right. The advantage of this approach is that it may (though not necessarily) match priority with the contemplation of the parties at the time of creation. The disadvantage of this approach is that it requires creditors to conduct additional due diligence (e.g. searches for new registrations) and to execute additional agreements and make additional registrations for amounts of credit extended subsequent to the time of the creation of a security right. This is particularly problematic in the case of revolving credit facilities, which represent one of the most effective means of providing secured credit, since this type of credit facility most efficiently matches the grantor's unique borrowing needs (see chap. II, Scope of application and other general rules, sect. F, Examples of financing practices covered, paras. [...]).

31. In yet other jurisdictions, priority is limited to the maximum amount specified in the notice registered in a public registry with respect to the security right. The rationale for this approach is that it encourages subordinate financing by encouraging prospective subordinate creditors to extend credit on the "equity" in encumbered assets (e.g. the value of the encumbered assets in excess of the maximum amount secured by the higher-ranking security right referred to in the registered notice). One argument against this approach is that it merely encourages secured creditors to inflate the amount mentioned in the registered notice to include an amount greater than that contemplated at the time of the security agreement to accommodate unanticipated future advances (see chap. VI, The registry system, paras. [...]).

32. In yet other jurisdictions, priority is accorded to all amounts of credit, even if extended after the creation of the security right, and for all contingent obligations that may arise after the creation of the security right, without the need to specify a maximum amount. In such systems, a security right may extend to all secured monetary and non-monetary obligations owed to the secured creditor and secured by the security right, including principal, costs, interest and fees, as well as performance obligations and other contingent obligations. Priority is unaffected by the date on which an advance or other obligation secured by the security right is

made or incurred. This means that a security right may secure future advances under a credit facility with the same priority as advances made under the credit facility contemporaneously with the creation of the security right (see A/CN.9/631, recommendations 74 and 76).

33. The Guide recommends that the priority of a security right should extend to all obligations secured under a security agreement. However, if a State determines that limiting the maximum amount of the secured obligation in the registered notice will encourage subordinate lending, priority may be limited to the maximum amount stated in the registered notice (see A/CN.9/631, recommendation 74; for the discussion of a possible limitation of priority in the case of a priority conflict with a judgement creditor, see paras. 90 and 91 below and recommendation 90).

4. Irrelevance of knowledge of the existence of the security right

34. In many legal systems, the ordering of priority according to the time of registration applies even if the creditor acquired its security right with knowledge of an existing unregistered security right. This rule is generally predicated on the premise that it is often difficult to prove that a person had knowledge of a particular fact at a particular time. This is particularly true in the case of a legal person. As a result, priority rules that are dependent on knowledge provide opportunities to subject registrations to challenge and complicate dispute resolution, thereby diminishing certainty as to the priority status of secured creditors and hence reducing the efficiency and effectiveness of the system.

5. Subordination

35. In most jurisdictions, a secured creditor may at any time subordinate, either unilaterally or by agreement, its security right to the right of an existing or future competing claimant. For example, Lender A, holding a security right in all existing and after-acquired assets of a grantor, may agree to permit the grantor to give a first-priority security right in a particular asset to Lender B so that the grantor could obtain additional financing from Lender B based on the value of that asset. The recognition of the validity of subordination of security rights reflects a well-established policy (see, for example, article 25 of the United Nations Assignment Convention).

36. However, subordination cannot affect the rights of a competing claimant without its consent. Thus, for example, a subordination agreement cannot adversely affect the priority of a secured creditor that is not a party to that agreement (see A/CN.9/631, recommendation 77). Under this approach, it is essential that the priority afforded by a subordination agreement continue to apply in an insolvency proceeding of the grantor. In fact, in some jurisdictions, such a provision in the insolvency laws may be necessary to empower the courts to enforce a subordination agreement and to empower insolvency representatives to deal with priority conflicts among parties to subordination agreements without risk of liability (see chap. XI, Insolvency, para. [...], and A/CN.9/631, recommendation 181).

37. Subordination of security rights and other proprietary rights in encumbered assets does not mean subordination of payments prior to default, which is a matter for contract law. Normally, prior to default and as long as the grantor services the loan or other credit received, the secured creditor is not entitled to enforce its

security right and priority is not an issue. Thus, in the absence of an agreement to the contrary, a grantor is not precluded from making payments on obligations secured by subordinate security rights (as to priority in a case where a subordinate claimant receives proceeds from the collection, sale or other disposition of an encumbered receivable, see chap. X, Post-default rights, paras. [...]).

6. Priority between security rights in the same encumbered assets

38. One of the cornerstones of an effective secured transactions regime is the manner in which it resolves priority disputes among competing security rights in the same encumbered assets. Such priority disputes may involve security rights that are made effective against third parties by registration, security rights that are made effective against third parties by another method, or a combination of security rights that are made effective against third parties by registration and security rights that are made effective against third parties by another method.

39. In many legal systems that have a general security rights registry, priority among security rights that were made effective against third parties by registration, subject to limited exceptions (see para. 45 below), is determined by the order in which registration occurs, regardless of the order of creation, even if one or more of the requirements for the creation of a security right were not satisfied at that time (see A/CN.9/631, recommendation 78, subpara. (a)).

40. This approach may be illustrated by the following example. A Grantor applies to Secured Creditor 1 for a loan, to be secured by a security right in all of the Grantor's existing and future equipment (a security right that may be made effective against third parties by registration of a notice in the general security rights registry). On Day 1, Secured Creditor 1 conducts a search of the registry, which confirms that no other notices have been filed with respect to security rights of other creditors in the Grantor's equipment. On Day 2, Secured Creditor 1 enters into a security agreement with the Grantor, in which Secured Creditor 1 commits to make the requested secured loan. On Day 3, Secured Creditor 1 registers a notice of the security right in the general security rights registry, but it does not make the loan to the Grantor until Day 5. Thus, the security right of Secured Creditor 1 was created and became effective against third parties on Day 5 (i.e. the first time when all of the requirements for creation and third-party effectiveness were satisfied). However, on Day 3, the Grantor enters into a security agreement with Secured Creditor 2, providing for a loan to be made by Secured Creditor 2 to the Grantor to be secured by a security right in the Grantor's existing and future equipment, and on the same day Secured Creditor 2 registers a notice of the security right in the general security rights registry and grants the loan to the grantor. As a result, the security right of Secured Creditor 2 was created and made effective against third parties on Day 3. Under the first-to-register approach described above, Secured Creditor 1's security right would have priority over Secured Creditor 2's, regardless of the fact that Secured Creditor 2's security right was created and made effective against third parties before Secured Creditor 1's security right.

41. The primary reasons for this approach are: (a) to encourage advance registration (which provides notice to third parties); and (b) to provide certainty to secured creditors by enabling them to determine the priority of their security rights before they extend credit. In the above example, if Secured Creditor 1 searches the registry on Day 2 after it registers its notice and determines that there are no other

notices in the registry that cover the relevant encumbered asset, Secured Creditor 1 can make its loan on Day 5 knowing with certainty that its security right will have priority over any other security right in the encumbered asset that may be created by the grantor in the future, because the priority of Secured Creditor 1's security right dates back to the time of its registration. By enabling Secured Creditor 1 to achieve this high level of certainty, the first-to-register approach can be a significant factor in promoting secured credit.

42. This certainty would not exist under an alternative approach, adopted in some jurisdictions, that accords priority to the first security right to become effective against third parties, since there would always be a risk that another security right could achieve third-party effectiveness, and thus priority, after Secured Creditor 1 conducts its search of the record but before it makes its loan. This risk would exist regardless of how short that time period might be.

43. In the case of a priority dispute among security rights made effective against third parties by methods other than registration, priority is normally accorded to the security right that is first made effective against third parties (see A/CN.9/631, recommendation 78, subpara. (b)). This rule would apply, for example, in a situation where one security right in a particular encumbered asset was made effective against third parties by possession and another security right in the same asset was made effective automatically upon its creation. In the case of security rights achieving third-party effectiveness by possession, there is no need for a "first-to-obtain-possession" rule analogous to the "first-to-register" rule, as typically a secured creditor would obtain possession of the encumbered asset at the same time it extends credit. In any case, such a "first-to-obtain-possession" rule would not be necessary for security rights in negotiable instruments or negotiable documents, if possession of them would give a superior right than is obtained by registration (see A/CN.9/631, recommendations 99 and 107).

44. In the case of priority disputes among security rights made effective against third parties by registration and security rights made effective against third parties by other methods, priority is accorded to the first security right to be registered or made effective against third parties, whichever occurs first (see A/CN.9/631, recommendation 78, subpara. (c)). This rule represents a logical extension of the first-to-register rule, using the registry as a basis for enabling secured creditors to achieve a high level of certainty with respect to the priority of their security rights. The rule also encourages the use of the registry for making security rights effective against third parties.

45. As noted above (see para. 39), the priority rules discussed herein are subject to limited exceptions. These exceptions reflect special priority rules relating to certain types of transaction or encumbered asset based on special policy or practical considerations relating to such transactions or assets. These types of transaction or asset are: (a) acquisition security rights (unitary approach) or acquisition financing rights (non-unitary approach) (see A/CN.9/631, recommendations 189-195, 198 and 199, in chap XII, Acquisition financing rights, sects. A and B, respectively); (b) cases in which third-party effectiveness is achieved by registration in a specialized registry (as is often the case for ships or aircraft) or notation on a title certificate (as is often the case for automobiles) (see A/CN.9/631, recommendations 83 and 84); (c) cases in which third-party effectiveness of security rights in rights to payment of funds credited to a bank account or proceeds under an independent

undertaking may be achieved by control (see A/CN.9/631, recommendations 101 and 105); (d) cases in which third-party effectiveness of security rights in negotiable instruments or negotiable documents may be achieved by possession (see A/CN.9/631, recommendations 99 and 107); (e) cases involving security rights in attachments (see A/CN.9/631, recommendations 93-95); and (f) situations involving security rights in masses of goods and products (see A/CN.9/631, recommendations 96-98).

7. Priority of a security right in after-acquired property

46. As discussed in greater detail in chapter IV, Creation of a security right (see paras. [...]), in some legal systems a security right may be created in property that the grantor may acquire in the future ("after-acquired property"). Such a security right is obtained automatically at the time the grantor acquires the property without any additional steps being required at that time. As a result, the costs incidental to the creation of the security right are minimized and the expectations of the parties are met. This is particularly important with respect to inventory that is continuously being acquired for resale, receivables that are continuously being collected and regenerated (see chap. II, Scope of application and other general rules, sect. F, Examples of financing practices covered, paras. [...]) and, to a lesser extent, equipment which is periodically being replaced in the normal course of the grantor's business.

47. The recognition of automatic creation of a security right in after-acquired property without additional steps being required at the time when the assets come into existence raises the question of whether the priority dates from the time when the security right is first registered or becomes effective against third parties, or from the time the grantor acquires the property. Different legal systems address this matter in different ways. The approach of some legal systems depends on the nature of the creditor competing for priority (with priority dating from the date of registration or third-party effectiveness vis-à-vis other consensual secured creditors, and from the date of acquisition by the grantor vis à vis all other creditors). It is generally accepted that dating priority from the time of registration or third-party effectiveness, rather than from the date the grantor acquires rights in the after-acquired assets, is the most efficient and effective approach in terms of promoting the availability of secured credit (see, for example, art. 8, para. 2, of the United Nations Assignment Convention). Thus, effective secured transactions regimes specify that a security right in after-acquired assets of the grantor has the same priority as a security right in assets of the grantor owned or existing at the time the security right is initially registered or made effective against third parties (see A/CN.9/631, recommendation 79).

8. Priority of a security right in proceeds

48. If a creditor has a security right in proceeds (for the definition of "proceeds", see Introduction, sect. B, Terminology and rules of interpretation, para. [...]), issues will arise as to the priority of that security right as against the rights of other competing claimants. Competing claimants with respect to proceeds may include, among others, another creditor of the grantor that has a security right in the proceeds and a creditor of the grantor that has obtained a right by judgement or execution against the proceeds.

49. Property that constitutes proceeds to one secured creditor may constitute original encumbered assets to another secured creditor. For example, Creditor A may have a security right in all of the grantor's receivables by virtue of its security right in all of the grantor's existing and future inventory and the proceeds arising upon the sale or other disposition thereof, and Creditor B may have a security right in all of the grantor's existing and future receivables as original collateral. If the grantor later sells on credit inventory that is subject to the security interest of Creditor A, both creditors have a security right in the receivables generated by the sale: Creditor A has a security right in the receivables as proceeds of the encumbered inventory, and Creditor B has a security right in the receivables as original encumbered assets.

50. The priority rules may differ depending on the nature of the competing claimant. When the competing claimant is another secured creditor, the priority rules for rights in proceeds of original encumbered assets may be derived from the priority rules applicable to rights in original encumbered assets. In a legal system in which the first right in particular property that is reflected in a registration has priority over the rights of a competing claimant, that same rule could be used to determine the priority when the original encumbered asset has been transferred and the secured creditor now claims a right in proceeds. If a registration was made with respect to the right in the original encumbered asset before the competing claimant made a registration with respect to the proceeds, the first security right could be given priority (see A/CN.9/631, recommendation 80).

51. In cases in which the order of priority of competing rights in the original encumbered asset is not determined by the order of registration (as is the case, for example, with acquisition financing rights that enjoy a super-priority), a separate determination will be necessary for the priority rule that would apply to proceeds (see chap. XII, Acquisition financing rights, paras. [...]).

9. Continuity in priority

52. In jurisdictions in which the third-party effectiveness of a security right may be established by more than one method (e.g. automatically, by registration, by possession or by control), a question arises as to whether a secured creditor that initially established the priority of its security right by one method should be permitted to change to another method without losing the original priority. In principle, there is no reason for a security right to lose its priority in this situation, provided there is no time during which the security right is not effective against third parties, so that the security right is subject to one method of third-party effectiveness or another at all times.

53. For example, if a security right in an asset first becomes effective by registration and the secured creditor subsequently obtains possession of the asset while the registration is still effective, the security right remains effective as against third parties and priority relates back to the time of registration. If, however, the secured creditor obtains possession of the asset after the registration has lapsed through the passage of time or otherwise, the priority of the security right dates from the time when the secured creditor obtained possession (see A/CN.9/631, recommendations 81 and 82; see also recommendations 47 and 48, which provide that third-party effectiveness is continuous and, if it lapses, it dates from the time it is re-established).

10. Priority of a security right registered in a specialized registry or noted on a title certificate

54. In many jurisdictions, a security or other right (such as the right of a buyer or lessee of an encumbered asset) may be registered in the general security rights registry or in a specialized registry, or it may be noted on a title certificate (see A/CN.9/631, recommendation 39). The question arises in this case as to which right has priority, as between the right registered in the general security rights registry and the right registered in the specialized registry or noted on a title certificate.

55. In many jurisdictions, a security right or other right registered in a specialized registry or noted on a title certificate has priority over a security right registered in a general registry (see A/CN.9/631, recommendation 83). The reason for this approach is to enable specialized registries to serve effectively their primary purpose of protecting buyers of the assets subjected to specialized registration. Under this approach, buyers of such assets can have full confidence in the completeness of the records in the system when assessing the quality of the title they are acquiring.

11. Rights of buyers, lessees and licensees of encumbered assets

(a) General

56. When a grantor sells assets that are subject to existing security rights, the buyer, lessee or licensee has an interest in receiving the assets free and clear of any security right, whereas the existing secured creditor has an interest in maintaining its security right in the assets sold (subject to certain exceptions; see para. 59 below). It is important that priority rules address both of these interests and that an appropriate balance be struck. If the rights of a secured creditor in particular assets are put at risk every time its grantor sells such assets, their value as security would be severely diminished and the availability of secured credit based on the value of such assets would be jeopardized.

57. The general principle is that a buyer or other transferee takes an encumbered asset subject to a security right and a lessee or licensee's rights are limited by a security right (*droit de suite*; see chap. V, Effectiveness of a security right against third parties, paras. [...]; see also A/CN.9/631, recommendations 32 and 85). In other words, the secured creditor may follow the asset in the hands of the buyer or other transferee, lessee or licensee. Exceptions to this general principle with respect to each of these three types of transaction are discussed below.

(b) Rights of buyers

58. As already mentioned (see chap. V, Effectiveness of a security right against third parties, paras. [...]; and chap. IV, Creation of a security right, paras. [...]), when an encumbered asset is sold, the secured creditor retains its security right in the original encumbered asset and also obtains a security right in the proceeds of the sale. In this situation, a question arises as to whether the security right in proceeds should replace the security right in the encumbered asset. It is sometimes argued that it should, on the premise that the secured creditor is not harmed by a sale of the assets free of its security right so long as it retains a security right in the proceeds of the sale. However, this would not necessarily protect the secured creditor, because proceeds are often not as valuable to the creditor as the original encumbered assets. In many instances, the proceeds may have little or no value to the creditor as

security (e.g. a receivable that cannot be collected). In other instances, it might be difficult for the creditor to identify the proceeds and its claim to the proceeds may, therefore, be illusory. In addition, there is a risk that the proceeds, even if they are of value to the secured creditor, may be dissipated by the seller that receives them, leaving the creditor with nothing. Jurisdictions have taken a number of different approaches to achieving this balance between the interests of secured creditors and persons buying encumbered assets from grantors in possession. The Guide takes the position that the secured creditor should retain its security right in the original encumbered asset and also a security right in the proceeds of its sale or other disposition (see A/CN.9/631, recommendations 18, 32, 40, 41 and 85). In any case, the secured creditor cannot receive more than it is owed.

59. However, most States recognize two exceptions to the general principle that a security right in an asset continues to encumber the asset after its transfer, and the Guide does also. The first exception relates to situations in which the secured creditor expressly authorizes the sale (see A/CN.9/631, recommendation 86). A secured creditor may authorize such a sale, for example, because the proceeds are sufficient to secure payment of the secured obligation or because the grantor gives other assets as security. The second exception refers to situations in which the authorization by the secured creditor is inferred, because the encumbered assets are of such a nature that the secured party expects them to be sold free of the security right, or where it is in the best interest of the secured creditor that they be sold free of the security right (see A/CN.9/631, recommendation 87). States have framed this second exception in a number of different ways, as described in the following paragraphs.

(i) *The ordinary-course-of-business approach*

60. One approach taken in many jurisdictions is to provide that sales of encumbered assets consisting of inventory made by the grantor in the ordinary course of its business will result in the automatic extinction of any security rights that the secured creditor has in the assets without any further action on the part of the buyer, seller or secured creditor. The corollary to this rule is that when a sale of inventory is outside the ordinary course of the grantor's business, or when the sale relates to an asset other than inventory, the exception will not apply; such a sale does not extinguish the security right and the secured creditor may, upon a default by the grantor, enforce its security right against the encumbered asset in the hands of the buyer (unless, of course, the secured creditor has consented to the sale). Where the security agreement so provides, the sale itself may constitute a default entitling the secured creditor to enforce its security rights; otherwise, the secured creditor cannot do so until default has occurred (see A/CN.9/631, recommendation 87, subpara. (a)).

61. Under this approach, two requirements must be satisfied for the encumbered asset to be sold free of the security right. The first requirement is that the seller of the encumbered assets must be in the business of selling assets of that kind. Thus, the encumbered asset cannot be something that the seller does not typically sell. In addition, the sale cannot be concluded in a manner different than the manner typically followed by the seller (e.g. a sale by the seller outside of its typical distribution channels, as would be the case if the seller normally sells only to retailers and the sale at issue is to a wholesaler). The second requirement is that the

buyer must not have knowledge that the sale violates the rights of a secured creditor under a security agreement (for a rule of interpretation with respect to “knowledge”, see Introduction, sect. B, Terminology and rules of interpretation, para. [...]). This would be the case, for example, if the buyer had knowledge that the sale was prohibited by the terms of the security agreement. On the other hand, mere knowledge on the part of the buyer of the fact that the asset was subject to a security right would be insufficient. This approach has the advantage that it is consistent with the commercial expectation that the grantor will sell its inventory of goods (and indeed must sell it to remain financially viable), and that buyers of the goods will take them free and clear of existing security rights. Without such an exception to the principle that the security right continues in the asset in the hands of a buyer, a grantor’s ability to sell goods in the ordinary course of its business would be greatly hampered, because buyers would have to investigate claims to the goods prior to purchasing them. This would result in significant transaction costs and would greatly impede ordinary-course transactions.

62. This approach provides a simple and transparent basis for determining whether goods are sold free and clear of security rights. For example, the sale of equipment by an equipment dealer to a manufacturer that will use the equipment in its factory is clearly a sale of inventory in the ordinary course of the dealer’s business, and the buyer should automatically take the equipment free and clear of any security rights in favour of the dealer’s creditors. This result is in line with the expectations of all parties, and the buyer is certainly entitled to presume that both the seller and any secured creditor of the seller expect the sale to take place in order to generate sales revenue for the seller. On the other hand, a sale by the dealer of a large number of machines in bulk to another dealer would presumably not be in the ordinary course of the dealer’s business.

63. With respect to sales that are outside the ordinary course of the grantor’s business, as long as the creditor’s security right is subject to registration in a general security rights registry, the buyer may protect itself by searching the registry to determine whether the asset it is purchasing is subject to a security right and, if so, seek a release of the security right from the secured creditor.

64. In some jurisdictions, buyers of encumbered assets are permitted to take the assets free of the security right, even where the transaction is outside the ordinary course of the seller’s business, if the assets are low-cost items, for the reason that, in those jurisdictions, the secured transactions law does not permit registration of a security right in a low-cost item, or because the cost of registrations is high in relation to the cost of the asset, and it would be unfair to impose that cost on a buyer of the item. On the other hand, it may be argued that, if an item is truly low-cost, a secured creditor is unlikely to enforce its security right against the asset in the hands of the buyer. In addition, determining which items are sufficiently low-cost to be so exempted would result in setting arbitrary limits, which would have to be continually revised to respond to cost fluctuations resulting from inflation and other factors.

65. In some jurisdictions that have a registration system that is searchable only by the grantor’s name, rather than by a description of the encumbered assets, a purchaser that purchases the assets from a seller that previously purchased the assets from the grantor (a “remote purchaser”) obtains the assets free of the security rights granted by such grantor. This approach is taken because it would be difficult for a

remote purchaser to detect the existence of a security right granted by a previous owner of the encumbered assets. In many instances, remote purchasers are not aware that the previous owner ever owned the asset and, accordingly, have no reason to conduct a search against the previous owner. The problem with this approach is that impairs the reliability of a security right given by a seller because of the possibility that the asset will be sold without the secured creditor's knowledge to a remote buyer, either innocently or with the specific intention of stripping away the security right. However, this cost is outweighed by the policy in favour of protecting buyers. For this reason, the Guide recommends that, where a buyer of tangible property takes free of a security right granted by its seller, a remote buyer will also take free of the security right (see A/CN.9/631, recommendation 88).

66. One disadvantage of the ordinary-course-of-business approach is that it might not always be clear to a buyer (particularly in international trade) what activities might be within the ordinary course of the seller's business. Another disadvantage might be that, if this rule were applied only to sales of inventory and not sales of other goods, there could be confusion on the part of the buyer as to whether the goods it is buying constitute inventory of the seller. On the other hand, it should be noted that, in a normal buyer-seller relationship, it is highly likely that buyers would know the type of business in which the seller is involved and in these situations the ordinary-course-of-business approach would be consistent with the expectations of the parties. Therefore, the number of cases in which such confusion exists are rare in practice. On balance, the benefits of the ordinary-course-of-business approach outweigh its disadvantages. This approach facilitates commerce and allows secured creditors and buyers to protect their respective interests in an efficient and cost-effective manner without undermining the promotion of secured credit (see A/CN.9/631, recommendation 87, subpara. (a)).

(ii) *Other approaches*

67. Many States have taken a different approach to determining whether a buyer of encumbered assets takes title to the assets free of a security right created by the seller. In those States, a buyer of goods takes free of any security rights in the goods if the buyer purchases the goods in good faith (i.e. with no actual or constructive knowledge of the existence of the security rights) and without regard to whether the sale was in the ordinary course of business of the seller. One argument in favour of this approach is that good faith is a notion known to all legal systems and there exists significant experience with its application both at the national and international levels. It has also been argued that a presumption should exist that a buyer is acting in good faith unless it is proven otherwise. However, the problem with such an approach is that it focuses on a subjective criterion relating to the disposition of the buyer (which also raises evidentiary issues), rather than on the commercial expectations of all parties involved.

(c) **Rights of lessees**

68. Priority disputes sometimes arise between the holder of a security right in an asset granted by the owner/lessor of the asset that is effective against third parties and a lessee of such asset. In this context, the issue is not whether the lessee actually takes the asset free of the security right in the sense that the security right is cut off. Rather, the issue is whether the lessee's right to use the leased asset on the terms and

conditions set forth in the lease agreement are unaffected by the security right. The principal issue in this situation is whether, if the holder of such a security right enforced it, the lessee could nevertheless continue using the asset so long as it continued to pay rent and otherwise abide by the terms of the lease. The general principle discussed above (see para. 58) applies here as well. The asset is, in principle, subject to the security right and thus the secured creditor may enforce its security right upon default of the grantor, even if it means interrupting the use of the asset by the lessee under the terms of the lease.

69. As in the case of buyers of tangible property subject to a pre-existing security right, many jurisdictions recognize two exceptions to this general principle. Under either exception, the security right does not cease to exist. However, for the duration of the lease, the right of the secured creditor is limited to the lessor's interest in the property and the lessee may continue to enjoy uninterrupted use of the asset in accordance with the terms of the lease.

70. The first exception is a situation in which the secured creditor has authorized the grantor to enter into the lease unaffected by the security right (see A/CN.9/631, recommendation 86, subpara. (b) (i)).

[Note to the Commission: The Commission may wish to note that commentary with respect to the issue addressed in recommendation 86, subparagraph (b) (ii), will be added if the Commission decides that this subparagraph should be retained (see A/CN.9/631, recommendation 86, subpara. (b) (ii), note).]

71. The second exception relates to situations in which the lessor of the tangible property is in the business of leasing tangible property of that type, the lease is entered into in the ordinary course of the lessor's business and the lessee had no actual knowledge that the lease violated the rights of the secured creditor under the security agreement (see A/CN.9/631, recommendation 87, subpara. (b)). Such knowledge would exist if, for example, the lessee knew that the security agreement creating such security right specifically prohibited the grantor from leasing the property. However, the mere knowledge of the existence of the security right, as evidenced by a notice registered in the security registration system, would not be sufficient to defeat the rights of the lessee. This exception is based on similar policy considerations to those relating to the analogous exception for sales of goods in the ordinary course of the seller's business (see para. 66 above).

72. An effective secured transactions regime must also address the issue of a sub-lease. In situations in which the rights of a lessee of tangible property are deemed to be unaffected by a security right in the property granted by the lessor, it is generally considered appropriate that the rights of a sub-lessee will also be unaffected (see A/CN.9/631, recommendation 88).

(d) Rights of licensees

73. The same issues discussed above also arise in the context of licensing of intangible property that is subject to a security right created by the licensor and the general principle applicable to sales and leases of tangible property also applies to licences of intangible property (see A/CN.9/631, recommendation 85). Thus, if a security right in intangible property is effective against third parties, it will continue in the property in the hands of the licensee unless one of the exceptions mentioned below applies (see A/CN.9/631, recommendations 86 and 87).

74. The first exception is where the secured creditor has authorized the licence (see A/CN.9/631, recommendation 86, subpara. (b) (i)). As in the case of sales and leases of tangible property, it is generally thought to be unfair to penalize a licensee if the secured creditor has consented to the licensing.

75. The second exception (also analogous to similar exceptions for sales and leases of tangible property) is a situation involving a non-exclusive licensing of intangible property, where the licensor is in the business of granting non-exclusive licences of such property, the lease is entered into in the ordinary course of the licensor's business, and the licensee had no knowledge that the licence violated the rights of the secured creditor under the security agreement (see A/CN.9/631, recommendation 87, subpara. (c)). As in the case of sales and leases of tangible property, it is generally recognized that such knowledge would exist if, for example, the licensee knew that the security agreement creating such security right specifically prohibited the grantor from licensing the property. However, the mere knowledge of the existence of the security right, as evidenced by a notice registered in the security registration system, would not be sufficient to defeat the rights of the licensee.

76. It is important to note that this second exception relates only to non-exclusive licences of intangible property and does not apply to exclusive licences. Where a grantor is engaged in the business of licensing intangible property, a secured creditor holding a security right in the property generally will normally expect its grantor to grant non-exclusive licences of the property in order to generate revenues. Moreover, it is not reasonable to expect the licensee under a non-exclusive licence to search the general security rights registry to ascertain the existence of security rights in the licensed property. On the other hand, an exclusive licence of intangible property, under which the licensee is granted the exclusive right to use the property throughout the world, or even in a specific territory, is generally a negotiated transaction that is out of the ordinary course of the licensor's business. In the case of an exclusive licence, it is reasonable to expect the licensee to search the general security rights registry to determine if the licensed property is subject to a security right created by the licensor and to obtain an appropriate waiver or subordination of priority.

77. Finally, as in the case of sales and leases of tangible property, a secured transactions regime must address the case of sub-licensees. And, as with sales and leases, a strong argument exists in favour of ensuring that sub-licensee is unaffected by a security right created by the original licensor in those situations where the law deems the licence itself to be unaffected by the security right (see A/CN.9/631, recommendation 88).

(e) Rights of donees

78. The position of a recipient of an encumbered asset as a gift (a "donee") is somewhat different from that of a buyer or other transferee for value. Because the donee has not parted with value, there is no objective evidence of detrimental reliance on the grantor's apparently unencumbered ownership. As a result, in a priority dispute between the donee of an asset and the holder of a security right in the asset granted by the donor, a strong argument exists in favour of awarding priority to the secured creditor, even in circumstances where the security right was not otherwise effective against third parties. Accordingly, the general rule is that a

security right follows the asset in the hands of a transferee (see A/CN.9/631, recommendation 85) and exceptions are made only for transferees for value, such as buyers, lessees or licensees (see A/CN.9/631, recommendations 86-88).

12. Priority of preferential claims

79. In many jurisdictions, as a means of achieving a general social goal (e.g. protection of tax revenue or employee wages), certain unsecured claims are given priority, within or even outside insolvency proceedings, over other unsecured claims and, in some cases, over secured claims (including secured claims previously registered). For example, to protect claims of employees and the State, claims for unpaid wages and unpaid taxes are in some jurisdictions given priority over previously existing security rights. Because social goals differ from jurisdiction to jurisdiction, the precise nature of these claims (e.g. whether they relate to taxes, employee-related claims or other types of claims) and the extent to which they are afforded priority, also differ.

80. The advantage of establishing these preferential claims is that a social goal may be furthered. The possible disadvantage is that these types of priorities can proliferate in a fashion that reduces certainty among existing and potential creditors, thereby impeding the availability of secured credit. In addition, even if the preferential claims can be ascertained with certainty by an existing or potential creditor, such claims (whether arising within or outside of insolvency proceedings) will adversely affect the availability and cost of secured credit. The reason is that, as such claims diminish the economic value of an asset to a secured creditor, creditors will often shift the economic burden of such claims to the grantor by increasing the interest rate or by withholding the estimated amount of such claims from the available credit.

81. To avoid discouraging secured credit, the availability of which is also a social goal, the various social goals should be carefully weighed in deciding whether to provide a preferential claim. The trend with respect to preferential claims in modern legislation is that they are limited and permitted only to the extent that there is no other effective means of satisfying the underlying social objective and when the jurisdiction has determined that the impact of such claims on the availability of secured credit is acceptable. For example, in some jurisdictions, tax revenue is protected through incentives on company directors to address financial problems quickly or face personal liability, while wage claims are protected through a public fund.

82. If preferential claims exist, the laws establishing them should be sufficiently clear and transparent so that a creditor is able to calculate the potential amount of the preferential claims in advance and to protect itself. Some jurisdictions have achieved such clarity and transparency by listing all preferential claims in one law or in an annex to the law. Other jurisdictions have achieved it by requiring that preferential claims be registered in a public registry and by according priority to such claims only over security rights registered thereafter. In those jurisdictions, priority is awarded to security rights that are registered before the preferential claims are registered to the extent they secure obligations in existence as of the date the preferential claim is registered or obligations arising within a specified period thereafter (such as 45 60 days after the preferential claims are registered), if the pre-existing security rights secure a commitment to provide future advances.

However, a problem with adopting a registration requirement with respect to some preferential claims that arise immediately prior to an insolvency proceeding is that it may be difficult to calculate their amount or to file in time. The Guide seeks to achieve a balance with respect to preferential claims by not recommending registration of such claims, but rather recommending that the law should limit such claims, both in number and amount, and that, to the extent preferential claims exist, they should be described in the law in a clear and specific way (see A/CN.9/631, recommendation 89). In this way, prospective secured creditors can evaluate the possibility of such claims in deciding whether to extend secured credit.

13. Priority of rights of judgement creditors

83. In some legal systems, a security right that is effective against third parties is accorded priority over the rights of an unsecured creditor, unless the unsecured creditor has obtained a judgement with respect to its claim and has taken the actions prescribed by law to enforce the judgement (such as seizing specific property or registering the judgement).

84. Judgement creditors are given this priority in recognition of the legal steps they have taken to enforce their claims on the grounds that this result is not unfair to other general unsecured creditors because they have the same rights to reduce their claims to judgement but have not taken the time and the expense to do so. However, to avoid giving judgement creditors excessive powers in legal systems where a single creditor may institute insolvency proceedings, insolvency laws often provide that security rights arising from judgements obtained within a specified period of time prior to the insolvency proceeding may be avoided by the insolvency representative. In various jurisdictions, the judgement creditor's property right is extinguished or not recognized in the judgement debtor's insolvency proceeding.

85. Effective secured transactions regimes typically address this type of priority dispute by balancing carefully the interests of the judgement creditor and the secured creditor. On the one hand, the judgement creditor has an interest in knowing at a certain point of time whether there is sufficient value left unencumbered in the grantor's assets for the enforcement of the judgement. On the other hand, a strong policy argument exists in favour of protecting the rights of the secured creditor, on the ground that the secured creditor expressly relied on its security right as a basis for extending credit.

86. Many legal systems seek to achieve this balance by giving priority to a security right over a property right of a judgement creditor, so long as the security right became effective against third parties before the judgement creditor's property right arises (see recommendation 90). There are one exception and two limitations to this rule.

87. The exception relates to acquisition financing rights in encumbered assets other than inventory or consumer goods. Priority is accorded to the acquisition financing right even if it is not effective at the time the judgement creditor obtains rights in the encumbered assets, so long as the security right is made effective against third parties within the applicable grace period provided for such security rights. A contrary rule would create an unacceptable risk for providers of acquisition financing that had already extended credit prior to the time when the judgement

creditor obtained its property right, and thus would discourage acquisition financing (see A/CN.9/631, recommendation 194).

88. The limitations to the rule mentioned above relate to limitations in the amount of credit given priority. The first limitation arises from the need to protect existing secured creditors from making additional advances based on the value of assets subject to judgement rights. There should be a mechanism to put creditors on notice of such judgement rights. In many jurisdictions in which there is a registration system, this notice is provided by subjecting judgement rights to the registration system. If there is no registration system or if judgement rights are not subject to the registration system, the judgement creditor might be required to notify the existing secured creditors of the existence of the judgement. In addition, the law may provide that the existing secured creditor's priority continues for a period of time (perhaps 45-60 days) after the judgement right is registered (or after the creditor receives notice), so that the creditor can take steps to protect its rights accordingly. The less time an existing secured creditor has to react to the existence of judgement rights and the less public such judgement rights are made, the more their potential existence will negatively affect the availability and cost of credit facilities that provide for future advances.

89. The Guide recommends the secured creditors on record should be notified and that the priority of any security right should extend to credit extended by the secured creditor a certain number of days (e.g. 30-60) after the secured creditor had been notified of the existence of the judgement creditor's right (see A/CN.9/631, recommendation 90, subpara. (a)). Although this limitation imposes an obligation on the judgement creditor to notify the secured creditor of its right, that is generally not overly burdensome for the judgement creditor and relieves the secured creditor of the obligation to search frequently for judgements against the grantor (which would be a far more burdensome and costly obligation). The existence of the grace period is justified on the ground that it prevents the secured creditor under a revolving loan facility or other credit facility providing for future extensions of credit from having to cut off loans or other credit immediately, a circumstance that could create difficulties for a grantor or even force a grantor into insolvency.

90. The second limitation relates to future advances. The priority of a security right may be extended to advances made even after the secured creditor is notified of the judgement creditor's rights, provided the advance was irrevocably committed, prior to that notice, in a fixed amount or an amount that may be determined pursuant to a specified formula (see A/CN.9/631, recommendation 90, subpara. (b)). A security right securing credit not committed but extended before the secured creditor is notified of the judgement creditor's rights does not have priority on the ground that the judgement creditor should be able to determine at some point in time whether any value would be left for the judgement creditor to enforce the judgement.

91. The rationale for this rule is that it would be unfair to deprive a secured creditor that has irrevocably committed to extend credit of the priority that it relied on when entering into the commitment. The contrary argument is that, under many credit facilities, the existence of a judgement would constitute an event of default, entitling the secured creditor to cease extending additional credit. However, that result would be unfair to the grantor, because the sudden loss of credit could well force the grantor into an insolvency proceeding. By recommending this rule, the

Guide resolves this priority dispute in favour of the continued extension of credit under an irrevocable credit facility, in the interest of allowing the grantor to remain in business (a circumstance that may result in the greatest chance for the grantor to pay all of its obligations).

14. Priority of rights of persons providing services with respect to an encumbered asset

92. In some legal systems, creditors that have provided services with respect to or have added value to tangible encumbered assets in some way, such as by storing, repairing or transporting them, are given a property right in the assets while the assets are in the possession of the service providers. This treatment of service providers has the advantage of inducing them to continue providing services and of facilitating the maintenance and preservation of encumbered assets.

93. In many jurisdictions, the property right given to service providers in assets in their possession ranks ahead of other security rights in those assets. The rationale underlying this priority rule is that service providers are not professional financiers and should be relieved of searching the registry to determine the existence of competing security rights before providing services. Moreover, the rule facilitates services such as repairs and other improvements that often benefit secured creditors.

94. A question arises as to whether the priority given to service providers should be limited in amount or recognized only in certain circumstances. One approach is to limit priority to an amount (such as one month's rent in the case of landlords) and to recognize their priority over pre-existing security rights only where value is added which directly benefits the holders of the pre-existing security rights. This approach would have the advantage that the rights of secured creditors would not be unduly limited. It would have the disadvantage though that service providers that did not add value would not be protected and, in any case, the amount of the value added by the service providers would need to be determined, a requirement that may add costs and create litigation.

95. Another approach is to limit the priority of service providers to the reasonable value of services provided. Such an approach would reflect a fair and efficient balance between the conflicting interests. It would ensure reasonable protection of service providers, while avoiding difficult questions of proof as to the relative value of the encumbered assets before and after the services are rendered (see A/CN.9/631, recommendation 91).

15. Priority of a supplier's reclamation right

96. In many legal systems, a supplier selling goods on unsecured credit may, upon default or financial insolvency of the buyer, be given by law a right to reclaim the goods from the buyer within a specified period of time (known as the "reclamation period"). If an insolvency proceeding has commenced with respect to the buyer, applicable insolvency law will determine the extent to which the reclamation claimants would be stayed or their rights would otherwise be affected (see recommendations 39-51 of the UNCITRAL Insolvency Guide).

97. An important question is whether a reclamation claim relating to specific tangible property should have priority over a pre-existing security right in the same property. In other words the question is whether, if the inventory of the buyer

(including the property sought to be reclaimed), is subject to effective security rights in favour of a secured creditor, the reclaimed property should be returned to the seller free of such security rights. In some jurisdictions, the reclamation has a retroactive effect, placing the seller in the same position it was prior to the sale (i.e. holding property that was not subject to any security rights in favour of the buyer's creditors). However, in other jurisdictions the property remains subject to the pre-existing security rights, provided that the security right had become effective against third parties before the supplier exercises its reclamation right, on the basis that any other result would be unfair to a pre-existing creditor of the buyer that had relied on the existence of such property in extending credit, and would also promote uncertainty and thereby discourage inventory financing (see A/CN.9/631, recommendation 92).

16. Priority of a security right in an attachment

98. To the extent that a secured transactions regime permits security rights to be created in attachments to immovable property (as recommended by this Guide; see A/CN.9/631, recommendation 22), it includes rules governing the relative priority of a holder of security rights in an attachment to immovable property vis-à-vis persons that hold rights with respect to the related immovable property. A paramount consideration of such priority rules is to avoid unnecessarily disturbing well-established principles of immovable property law.

99. Such priority rules address a number of different priority conflicts. The first is a priority conflict between a security right in an attachment (or any other right in an attachment such as the right of a buyer or a lessee), that is created and made effective against third parties under immovable property law, on the one hand, and a security right in the attachment that is made effective against third parties under the movable property secured transactions regime, on the other hand. In this situation, out of deference to immovable property law, priority is accorded to the right created under immovable property law (see A/CN.9/631, recommendation 93).

100. A second priority conflict may arise between: (a) a security right in an encumbered asset that is either an attachment to immovable property at the time the security right becomes effective against third parties or that becomes an attachment to immovable property subsequently; and (b) a security right in the attachment (or other right in the attachment such as the right of a buyer or lessor) in the related immovable property. In this case, priority is accorded to the right described under (a), on the ground that, as both competing security rights achieved third-party effectiveness in the immovable property registry, priority should be determined according to the order of registration in the immovable property registry in order to preserve the reliability of that registry (see A/CN.9/631, recommendation 94).

101. The general rules applicable to the priority of security rights in movable property apply to priority conflicts between security rights in attachments to movable property. A special rule may be required to address a priority conflict between: (a) a security right in an attachment (or any other right in an attachment such as the right of a buyer or lessee) that was made effective against third parties by registration in a specialized registry or notation on a title certificate; and (b) a security right or other right in the related movable property that is registered subsequently. Typically, priority is given to the right under (a) in deference to the

policy in favour of preserving the integrity of specialized registries and title-notation systems (see A/CN.9/631, recommendation 95).

17. Priority of a security right in a mass or product

102. There are three types of potential priority contests that require special rules. Using the example of the ingredients in a cake, these three types are: (a) contests between security rights taken in the same items of tangible property that ultimately become part of a mass or product (e.g. sugar and sugar); (b) contests involving security rights in different items of tangible property that ultimately become part of a mass or product (e.g. sugar and flour); and (c) contests involving a security right originally taken in separate tangible property and a security right in the mass or product (e.g. sugar and cake).

(a) Priority of security rights in the same items of tangible property that become part of a mass or product

103. Security rights in items of tangible property that become commingled normally have the same priority vis-à-vis each other as they had in the separate property. The rationale for this rule is that the incorporation of tangible property into a mass or product should have no bearing on the respective rights of creditors with competing security rights in the separate items of tangible property (see A/CN.9/631, recommendation 96). This rule is predicated on the assumption that a secured creditor may not receive an amount greater than the value of the tangible property immediately before it became part of the mass or product (see A/CN.9/631, recommendation 23).

(b) Priority of security rights in different items of tangible property that become part of a mass or product

104. If security rights in different items of tangible property that ultimately become part of a mass or product continue in the mass or product, the security rights have the same priority and the issue is to determine the relative value of the rights. Normally, the secured creditors are entitled to share in the aggregate maximum value of their security rights in the mass or product according to the ratio of the value of their security rights (see A/CN.9/631, recommendation 97). Using the example of the cake, if the value of the sugar is 2 and the flour 5, while the value of the cake is 6, the creditors will receive two sevenths and five sevenths of 6, but neither secured creditor will receive more than the amount of its secured obligation. In any case, if the value of the mass or product is less than the amount of the secured obligations, there will be no value left for unsecured creditors.

(c) Priority of a security right originally taken in different items of tangible property as against a security right in the mass or product

105. Security rights in items of tangible property have priority over all security rights in the mass or product that extend to future property only if the former are acquisition security rights (see A/CN.9/631, recommendation 98). Otherwise, the general priority rules apply. This rule is intended to promote the availability of credit for the acquisition of tangible property, without which no mass or product could be produced.

B. Asset-specific remarks

106. This section of the commentary discusses issues with respect to security rights in types of asset that require special priority rules. Security rights in types of asset to which the general rules apply (e.g. tangible property or receivables) are discussed in section A above.

1. Priority of a security right in a negotiable instrument

107. Many jurisdictions have adopted special priority rules for security rights in negotiable instruments, such as cheques, bills of exchange and promissory notes (for the definition of “negotiable instrument”, see Introduction, sect. B, Terminology and rules of interpretation, para. [...]). These rules are a reflection of the importance of the concept of negotiability in those jurisdictions.

108. As discussed (see chap. V, Effectiveness of a security right against third parties, paras. [...]), in many jurisdictions security rights in negotiable instruments may be made effective either by registration of the security right in the general security rights registry or by transfer of possession of the instrument (see A/CN.9/631, recommendation 38). In these jurisdictions, priority is often accorded to a security right made effective against third parties by transfer of possession of the instrument over a security right made effective against third parties by registration, regardless of when registration occurs (see A/CN.9/631, recommendation 99). The rationale for this priority rule is that it resolves the priority conflict in favour of preserving the unfettered negotiability of negotiable instruments.

109. For the same reason, in those jurisdictions, priority is often accorded to a buyer or other transferee (in a consensual transaction), if that person either qualifies as a protected holder of the instrument under the law governing negotiable instruments (for a rule of interpretation with respect to the expression “law governing negotiable instruments”, see Introduction, sect. B, Terminology and rules of interpretation, para. [...]) or takes possession of the instrument and gives value in good faith and without knowledge that the transfer is in violation of the secured creditor’s rights (see A/CN.9/631, recommendation 100). It should be noted in this regard that knowledge of the existence of a security right on the part of a transferee of an instrument or a document does not mean, by itself, that the transferee did not act in good faith.

2. Priority of a security right in a right to payment of funds credited to a bank account

110. A comprehensive priority regime typically addresses a number of different priority conflicts relating to security rights in rights to payment of funds credited to a bank account (for a definition of “bank account”, see Introduction, sect. B, Terminology and rules of interpretation, para. [...]). One type of priority conflict is between a security right made effective against third parties by control and a security right made effective against third parties by a method other than control. In this situation, many jurisdictions accord priority to the security right made effective against third parties by control, because that outcome facilitates financial transactions that rely on funds credited to a bank account, relieving secured

creditors from the necessity of searching the general security rights registry (see A/CN.9/631, recommendation 101, first sentence). In a sense, the existence of a control agreement in this situation functions like a specialized security rights registry.

111. Another type of priority conflict is a conflict between two security rights, each of which is made effective by control. Here, the logical outcome is to accord priority to the security right that was first made effective by control (see A/CN.9/631, recommendation 101, second sentence). This conflict will not arise often in practice, because it is unlikely that a depositary bank will knowingly enter into more than one control agreement with respect to the same bank account in the absence of an agreement between both secured creditors as to how priority will be determined.

112. Yet another type of priority conflict is where one of the secured creditors is the depositary bank itself. In this situation, a strong argument exists in favour of according priority to the depositary bank (see A/CN.9/631, recommendation 101, third sentence), because that depositary bank generally will win in such a situation in any event by reason of its right of set-off under non-secured transactions law and a priority rule that favours the bank in this circumstance allows the conflict to be resolved within the confines of the secured transactions regime without resorting to other law. If a different rule were adopted, depositary banks would be reluctant to enter into any control agreements and, in any case, a secured creditor could obtain a subordination agreement from the bank before deciding to extend credit.

113. Jurisdictions that adopt this priority rule often make an exception for the circumstance in which the priority conflict is between the depositary bank and a secured creditor that obtains control of the bank account by becoming the customer of the depositary bank, and adopt a rule that accords priority to the customer. The rationale for this approach is that, by accepting the competing secured creditor as its customer, the depositary bank effectively agrees to subordinate its claim. Also, the depositary bank would often lose its right of set-off in this situation because there would be no mutuality between the depositary bank and the grantor since the bank account is not in the grantor's name.

114. A fourth type of conflict is a conflict between a security right in a right to payment of funds credited to a bank account and any rights of set-off the depositary bank might have against the grantor-client. To avoid undermining the bank-client relationship, secured transactions laws give priority to the depositary bank's rights of set-off (see A/CN.9/631, recommendation 102).

115. A fifth type of priority conflict is a conflict between a security right in a right to payment of funds credited to a bank account and a transferee of funds from the bank account initiated by the grantor. In this situation, a strong policy argument in favour of the free negotiability of funds supports a rule that accords priority to the transferee, so long as the transferee did not act in collusion with the holder of the bank account to deprive the secured creditor of its security right. Thus if the transferee takes the funds with knowledge that the transfer violates the security right under the security agreement, it takes the funds subject to the security right. The term "transfer of funds" is intended to cover a variety of transfers, including by cheque and electronic means of communication. (see A/CN.9/631, recommendation 103).

3. Priority of a security right in money

116. In the interest of maximizing the negotiability of money, many secured transactions regimes permit a transferee of money to take the money free of the claims of other persons, including the holders of valid security rights in the money (for the definition of “money”, see Introduction, sect. B, Terminology and rules of interpretation, para. [...]). As in the case of transferees of funds from a bank account, the only exception to this priority rule is if the transferee has colluded with the holder of the bank account to deprive the secured creditor of its rights (e.g. if the transferee has knowledge that the transfer of the money is in violation of the security agreement between the account holder and the secured party. On the other hand, mere knowledge of the existence of the security right does not defeat the rights of the transferee under this rule (see A/CN.9/631, recommendation 104).

4. Priority of a security right in proceeds under an independent undertaking

117. As already mentioned (see chap. V, Effectiveness of a security right against third parties, see para. [...]), a security right in proceeds under an independent undertaking is made effective against third parties only by control. As the typical method of achieving control in this context is by obtaining an acknowledgment, in the case of several potential payors (e.g. the guarantor/issuer, confirmer and several nominated persons), control is achieved only vis-à-vis each particular guarantor/issuer, confirmer or nominated person that gave an acknowledgment. Thus, the priority rule normally focuses on the particular person that is the payor.

118. Normally, a security right in proceeds under an independent undertaking that has been made effective by control, has, with respect to a particular guarantor/issuer, confirmer or nominated person that has given value under the independent undertaking, priority over all other security rights that have, with respect to that person, been made effective by a method other than control. As in the case of bank accounts (see para. 110 above), this rule is based on the need to facilitate transactions involving independent undertakings by relieving parties of the necessity of searching the general security rights registry. However, as between two security rights made effective against third parties by acknowledgement, priority is accorded to the first security right to be acknowledged (see A/CN.9/631, recommendation 105).

5. Priority of a security right in a negotiable document or goods covered by a negotiable document

119. Effective secured transactions regimes typically have rules that address at least two priority conflicts involving negotiable documents, such as negotiable warehouse receipts and bills of lading (for the definition of “negotiable document”, see Introduction, sect. B, Terminology and rules of interpretation, para. [...]). The first is a conflict between the holder of a security right in a negotiable document or the goods covered thereby, on the one hand, and a person to whom the document has been duly negotiated, on the other. In the interest of preserving negotiability under non-secured transactions law, priority is generally accorded to the transferee of the document (see A/CN.9/631, recommendation 106).

120. The second conflict is between the holder of a security right in the goods covered by the negotiable document that is derived from a security right in the

negotiable document and the holder of a security right in the goods resulting from another method (e.g. the creation of a direct security right in the goods). This type of conflict can arise in two distinct situations. One situation is where the security right in the goods was created while the goods were subject to the negotiable document. Here, a strong argument exists in favour of awarding priority to the holder of the security right in the document (see A/CN.9/631, recommendation 107). The second situation is where the security right in the goods became effective before the goods were covered by the negotiable document. In this situation, it is fair to award priority to that security right.

C. Recommendations

[Note to the Commission: The Commission may wish to note that, as document A/CN.9/631 includes a consolidated set of the recommendations of the draft legislative guide on secured transactions, the recommendations are not reproduced here. Once the recommendations are finalized, they will be reproduced at the end of each chapter.]

A/CN.9/631/Add.5 [Original: English]

Note by the Secretariat on recommendations of the UNCITRAL draft Legislative Guide on Secured Transactions, submitted to the Working Group on Security Interests at its twelfth session

ADDENDUM

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VIII. Rights and obligations of the parties

A. General remarks

1. Introduction

1. A security agreement sets out the bargain between the grantor and the secured creditor. Its substantive content will vary according to the needs and wishes of the parties. Typically, clauses in security agreements address three main themes. First, some provisions are included because they form part of the mandatory requirements for creating a security right. Rules relating to the identification of the encumbered asset and the secured obligation are of this type (for the definitions of “encumbered asset” and “secured obligation”, see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation). In chapter IV (Creation of a security right (effectiveness as between the parties)), this Guide recommends that the formal requirements for creating a security agreement that is effective as between the parties should be minimal and easy to satisfy (see A/CN.9/631, recommendations 12-14).

2. The typical security agreement will also contain several terms specifying the rights and obligations of the parties once the agreement has become effective between them. Many of these terms deal with the consequences of a default by the grantor or the breach of an obligation by the secured creditor. Often the events constituting a default by the grantor and the remedies available to the secured creditor to enforce the terms of the security agreement are enumerated in detail. The significant impact that enforcement may have on the rights of third parties usually has led States to specify in some detail a series of mandatory rules governing default and enforcement (see chapter X, Post-default rights). Nonetheless, unless the terms of the security agreement relating to a creditor’s contractual rights and remedies conflict with mandatory rules or are waived by the grantor after default (see A/CN.9/631, recommendation 130) or by the secured creditor at any time (see A/CN.9/631, recommendation 131) they will govern the relationship between the parties once a default occurs.

3. In addition, security agreements usually contain a series of other provisions meant to regulate the relationship between the parties after creation but prior to default. That is, efficiency and predictability in secured transactions often call for additional detailed clauses aimed at covering particular aspects of the ongoing transaction. Many States actively encourage the parties themselves to fashion the terms of the security agreement to meet their own requirements. Nonetheless, these same States are also anxious to frame certain mandatory rules to govern pre-default rights and obligations (especially when third-party rights may be in play). However, in order to enhance the flexibility offered to grantors and secured creditors to tailor-make their agreement, States usually keep these mandatory pre-default rules to a minimum.

4. While States are generally reluctant to specify a full menu of mandatory rules governing the pre-default relationship between the parties, this does not mean that they have no interest in providing guidance to grantors and secured creditors. Indeed, many States enact a greater or lesser number of other, non-mandatory (or suppletive) rules detailing the parties’ rights and obligations before default,

should they not specify these terms in the security agreement. This chapter does not address all the situations where States may wish to develop non-mandatory rules. Rather, it offers only an indicative and non-exhaustive list of those non-mandatory rules concerning pre-default rights and obligations which are commonly found in contemporary national legislation.

5. The discussion that follows focuses on three policy issues. The first, examined in section A.2, relates to the principle of party autonomy and the extent to which parties should be free to fashion the terms of their security agreement (assuming that the agreement satisfies the substantive and formal requirements for the creation of a security right). The second, explored in section A.3, relates to the mandatory rules that should govern pre-default rights and obligations of grantors and secured creditors. The third, which is the subject of sections A.4 and A.5, concerns the type and number of non-mandatory rules that could be included in modern secured transactions legislation, so as to encompass new and evolving forms of secured transactions.

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

2. Party autonomy

7. In chapter II (Scope of application and other general rules), this Guide announces the principle of party autonomy as one of the foundations of its basic approach (see A/CN.9/631, recommendation 8). The central idea is that, unless a State provides otherwise, the secured creditor and the grantor should be free to craft their security agreement as they see fit. While party autonomy gives credit providers significant power in determining the content of the security agreement, the expectation is that permitting the secured creditor and the grantor to structure their transaction and allocate pre-default rights and obligations as best suited to their objectives will normally permit grantors to gain wider access to secured credit.

8. The party autonomy principle has two distinct dimensions when applied to pre-default rights and obligations. The first is aimed at States. While States should be free to enact mandatory rules to govern the ongoing relationship between parties, their number should be limited and their scope clearly stated. The second is directed to the grantor and the secured creditor. Any agreement that derogates from or modifies non-mandatory rules only binds the parties to that agreement and does not affect the rights of third parties.

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

10. In addition to these mandatory rules that govern particular grantors and particular property, it is common for States to impose various mandatory rules of a more general character. These are usually found within the legislation that creates the secured transactions regime and, as noted, they most often relate to default and enforcement. But some also concern pre-default rights and obligations. These latter types of mandatory rules are discussed in the next section of this chapter.

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

(a) They will agree on the assets to be encumbered and the conditions under which assets not initially encumbered may later become encumbered;

(b) They will define the obligation to be secured as well as provide for any future obligations that may be secured under the agreement;

(c) They will attempt to specify what the grantor can and cannot do with the encumbered assets (including the right to use, transform, collect fruits from and dispose of the property);

(d) They will specify if, when and how the creditor may obtain possession of the encumbered assets prior to default, and the rights of the creditor with respect to those encumbered assets in its possession;

(e) They will specify a series of representations, warranties and obligations that the grantor undertakes; and

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

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

3. Mandatory pre-default rules

(a) General

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

14. Other pre-default mandatory rules focus on the substantive content that parties may include in their agreement. Usually these rules are conceived as general limitations on the rights of secured creditors. They can vary widely from State to State. For example, some States attempt to prevent creditor overreaching and over-collateralization by enacting rules that require creditors to grant a release over property that is no longer necessary to secure the outstanding balance of the

obligation due. Similarly, some States do not permit creditors to restrict the right of a grantor to use or transform the encumbered assets as long as this use or transformation is consistent with the nature and purpose of those assets.

15. Because of the importance that this Guide attaches to the principle of party autonomy it takes the position that States generally ought not to enact pre-default mandatory rules that restrict the number or nature of the obligations that secured creditors and grantors may require of each other. Still, the above concerns are often real and depending on the particular character of their national economy States may feel the need to more closely regulate certain aspects of the pre-default relationship between secured parties and grantors. Should they do so, however, it follows from the principle of party autonomy that such mandatory rules should (a) be expressed in clear and limited language; and (b) like similar rules in the post-default context, be based on recognized grounds of public policy (*ordre public*) such as good faith, fair dealing and commercial reasonableness (see A/CN.9/631, recommendations 128 and 129).

16. A third type of mandatory rule aims at ensuring that the fundamental purposes of a secured transactions regime are not distorted. Typically, States deploy rules of this type to impose minimum duties upon the party that has possession or control of the encumbered assets. So, for example, as the point of security is to provide a creditor with a priority right to claim, upon default, payment through the value of the encumbered asset, it would be consistent with the logic of the institution that grantors assume an obligation not to waste or otherwise allow the encumbered assets to deteriorate beyond what would be expected from normal usage.

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

18. Mandatory rules setting out pre-default rights and obligations (or any mandatory rules) may not be derogated from in the security agreement. For example, parties may not contract out of their duty to take reasonable care of the encumbered assets. However, this does not always disable parties from waiving a breach of the duty after the fact. Many States provide that the secured creditor may later release the grantor from its pre-default obligations or may waive any breaches by the grantor (even of obligations imposed by mandatory rules). By contrast, given the usual dynamic between secured creditor and grantor, many of these same States also provide that the grantor cannot release the secured creditor from any duties imposed by mandatory rules.

19. The mandatory pre-default rules recommended in this Guide aim at policy objectives consistent with what have been defined as the core principles of an effective and efficient regime of secured transactions. They set out pre-default rights and obligations that (a) encourage parties in possession to preserve the pre-default

value of the encumbered assets; and (b) ensure that once the obligation is paid, the grantor recovers the full use and enjoyment of the previously encumbered assets.

20. Chapter XII (Acquisition financing rights) of this Guide contemplates that some States might choose to preserve retention-of-title and financial lease transactions as independent forms of acquisition financing rights. In these situations, the seller's right is not a security right but rather constitutes ownership of the property sold until full payment of the purchase price (for the definitions of the terms "security right", "acquisition financing right", "retention of title" and "financial lease", see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation). For this reason, even though the fundamental economic objectives of the transaction are identical to those of an ordinary security right, the mandatory rules concerning pre-default rights and obligations of the parties (the seller that retains ownership and the buyer that has possession but only an expectancy of ownership) will have to be framed in slightly different language. These necessary adjustments are discussed in chapter XII, section A.8.

(b) Duty to preserve the encumbered assets

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

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

23. The specific content of the duty may vary considerably, depending on the nature of the encumbered asset. In the case of tangible property, the duty points first to the physical preservation of the asset (for the definitions of "tangible property" and "intangible property", see A/CN.9/631, Introduction, sect. B, Terminology and rules of interpretation). Where inanimate tangible property is concerned, this usually would include a duty to keep property in a good state of repair and not to use it for a purpose other than that which is normal in the circumstances. For example, if a piece of machinery is at issue, it must not be left out in the rain and the party that possesses and uses it must perform routine maintenance. If security is taken on a passenger automobile, the person in possession cannot use the vehicle as a light truck for commercial purposes.

24. In the case of living tangible property such as animals, the duty should be similar. It is not enough simply to keep the animal alive. The person in possession must ensure that the animal is properly fed and is maintained in good health (for example, receives adequate veterinary care). Where the animal requires special

services to maintain its value (for example, proper exercise for a race horse, regular milking for a cow), the duty of care extends to providing these services. Finally, as with equipment, the duty also means that the animal cannot be used for abnormal purposes. Thus, a prize bull the value of which lies in stud fees cannot be used as a beast of burden.

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

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

27. Consistent with the above considerations, this Guide recommends that States enact a general mandatory pre-default rule aimed at ensuring a fair allocation of responsibility for caring for encumbered assets and encouraging parties in possession to preserve the pre-default value of the encumbered assets (see A/CN.9/631, recommendation 109, subpara. (a)).

(c) Duty to return the encumbered asset and to terminate the notice

28. The central purpose of a security right is to enhance the likelihood that the grantor will repay any obligation owed to the secured creditor. A security right is not a means of expropriating surplus value from the grantor or a disguised transfer of that property to the creditor. For this reason, most States enact mandatory rules to regulate the duties of the secured creditor once the secured obligation has been repaid in full and all credit commitments have been terminated. These duties are of two types. Some duties relate to the return of the encumbered assets to the grantor, should the secured creditor be in possession of the assets during the duration of the agreement; other duties relate to ensuring that the grantor's rights to the encumbered assets are free from any residual encumbrance.

29. This Guide contemplates that secured creditors may make their rights effective against third parties by taking possession of the secured property (see A/CN.9/631, recommendation 35). In addition, even when creditor possession is not taken to achieve third-party effectiveness, given the principle of party autonomy, grantors

may agree to permit secured creditors to take possession of their assets at the time of creating the security right, or at some time thereafter, even if they are not in default. In either event, however, the secured creditor's possession is grounded in the agreement between the parties and relates to the specific objectives of that agreement. For this reason, most States enact mandatory rules governing the duties of a secured creditor that has possession or control of encumbered assets once the secured obligation has been repaid, or any commitments to extend further credit have been terminated.

30. Since the purpose of a security right is to ensure the performance of an obligation, once that performance has occurred, the grantor should be able to recover either possession of the encumbered assets or unimpeded access to them, or both. This explains the formal duty that many States impose on secured creditors to return the encumbered assets to the grantor upon full payment of the secured obligation (and termination of all credit commitments). The burden lies on the creditor to deliver the encumbered assets, and not on the grantor to reclaim them or to take them away. Likewise, where the secured creditor and a deposit-taking institution have entered into a control agreement, many States require the secured creditor specifically to inform the depositary that the control agreement is no longer in effect. Both of these requirements are intended to ensure that the grantor automatically acquires the free use of encumbered assets once the secured obligation has been paid in full and all credit commitments have been terminated.

31. Some States consider that the creditor must also take positive steps to ensure that the grantor is placed in the same position that it occupied prior to the creation of the security right. In the case of intangible property, this would require sending a notice to any third-party obligor (for example, the debtor of a receivable) indicating that the secured obligation has been paid in full and that the grantor is again entitled to receive payment of the receivable (for the definitions of "receivable" and "debtor of the receivable", see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation). More generally, some States oblige secured creditors to release the encumbered assets from the security right and to ensure that evidence of that security right be expunged from the record of the relevant registry. So, for example, where registrations are not automatically purged from a registry, after a relatively short period of time creditors are often required to request the registry to cancel the registration. Similarly, where the security right has been made the subject of a notice on a title certificate, some States require the secured creditor to ensure the deletion of the notice on the title certificate. The unifying theme of these requirements is that the secured creditor should take whatever steps are necessary to ensure that no third party might think that the grantor's assets are still potentially subject to its security right.

32. The mandatory rule recommended in this Guide to govern the relationship of the parties once the secured obligation has been paid broadly reflects these considerations. Its primary objective is to make certain that the grantor recovers the full use and enjoyment of the previously encumbered property and is able to deal effectively with it in transactions involving third parties (see A/CN.9/631, recommendation 109, subpara. (b)).

4. Non-mandatory pre-default rules

33. In addition to various mandatory rules governing pre-default rights and obligations of the parties, most States develop a longer or shorter list of non-mandatory rules addressing the same issues. The vocabulary used to identify rules “subject to contrary agreement between the parties” varies from State to State (e.g. *jus dispositivum*, *lois supplétives*, *normas supletorias*, non-mandatory rules, default rules). Their common feature, however, is this: they are meant to apply automatically, unless there is evidence that the parties intended to exclude or amend them.

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

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

36. Second, even the best-advised and most experienced parties do not possess infallible insight into the future. However carefully drawn the agreement, there will be unforeseen circumstances. To obviate the need for a judicial or arbitral decision to fill these gaps when they arise and to reduce the number of potential disputes, States usually provide for basic characterization rules. These non-mandatory rules direct parties to other, more general, legal principles that can be deployed to guide the resolution of unanticipated problems. An example of such a rule is that which provides that the grantor of a security right remains the holder of the substantive right (be it ownership, a lesser property right or a personal right) over which security has been taken. Thus, in working through any particular unforeseen event, the parties may begin with the principle that the exercise of any right not specifically allocated to the secured creditor remains vested in the grantor.

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

38. Finally, non-mandatory rules make it possible for the principle of party autonomy to operate most efficiently. This benefit is particularly evident in long-term transactions or other speculative transactions where the parties cannot anticipate every contingency. Such rules facilitate flexibility and reduce compliance costs. For example, treating the agreement as complete in itself and requiring the parties to formalize all subsequent modifications and amendments to that agreement simply imposes additional transaction costs on the grantor.

39. The advantages of permitting the parties to define their relationship with the assistance of a set of non-mandatory rules are widely recognized by many national legal systems (e.g. arts. 2736-2742 of the Civil Code of Québec, Canada, and arts. 9-207 to 9-210 of the Uniform Commercial Code in the United States), by organizations that promote regional model laws (e.g. art. 15 of the European Bank for Reconstruction and Development Model Law on Secured Transactions and art. 33 of the Organization of American States Model Inter-American Law on Secured Transactions), and by international conventions dealing with international sales (i.e. art. 6 of the United Nations Convention on Contracts for the International Sale of Goods)¹ or some aspect of secured transactions in movable assets (e.g. art. 11, para. 1, of the United Nations Convention on the Assignment of Receivables in International Trade² (hereinafter the “United Nations Assignment Convention”) and art. 15 of the International Institute for the Unification of Private Law (Unidroit) Convention on International Interests in Mobile Equipment).

5. Typical non-mandatory pre-default rules

(a) General

40. This chapter does not address all of the situations where States may wish to develop non-mandatory rules. For example, it does not deal with non-mandatory rules that may be developed in relation to the basic terms required for a security right to exist (e.g. the minimum contents of the security agreement). Non-mandatory rules in this context fulfil a different function and their desirability, scope and content would, therefore, be governed by different policy considerations. Moreover, and for the same reason, it does not consider non-mandatory rules that are meant to govern post-default rights and obligations of the parties. These non-mandatory rules are addressed in chapter X (Post-default rights).

41. The non-mandatory rules discussed in this section are those directed to pre-default rights and obligations of the parties. Yet, because non-mandatory rules

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

² Ibid., Sales No. E.04.V.14.

will usually reflect the needs, practices and policies of particular States their specific configuration varies enormously. Still, there is a core of non-mandatory rules that are commonly found in contemporary national legislation. They serve as a complement to mandatory rules dealing with the rights and duties of persons in possession of encumbered assets.

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

(b) Creditor-in-possession security rights

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

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

45. Where the encumbered asset consists of an instrument embodying the grantor's right to the payment of money, the obligation of care on the part of the secured creditor is not limited to the physical preservation of that document. Many States require the secured creditor to take necessary steps to maintain or preserve the grantor's rights against prior parties bound under the negotiable instrument or secondarily liable, and also permit either the grantor or the secured creditor to sue for enforcement of the payment obligation.

46. Another non-mandatory rule (a corollary of the duty of the secured creditor in possession to take care of the encumbered asset) is that the secured creditor is entitled to obtain reimbursement for reasonable expenses required to preserve the asset and to have these expenses included within the secured obligation. In addition, many States permit the secured creditor to make reasonable use of or operate the encumbered asset (see A/CN.9/631, recommendation 108). As a concomitant of this right, the secured creditor must allow the grantor to inspect the encumbered asset at

all reasonable times and will be liable in damages for any deterioration of the asset beyond that associated with normal use.

47. Because the secured creditor is in possession, it will most often be in the best position to collect monetary proceeds (revenues or civil fruits) or non-monetary proceeds (natural fruits included in the definition of proceeds, see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation) derived from the encumbered asset. For this reason, it is common for States to enact a non-mandatory rule that both monetary and non-monetary proceeds are to be collected by the secured creditor in possession. Normally, it is the grantor that will be able to get the best price for the natural fruits generated by secured property (for example, milk produced by a herd of cows, eggs produced by chickens, wool produced by sheep). Therefore, States usually also provide that the secured creditor should turn the fruits over to the grantor for disposition. Alternatively, where the fruits involve the natural increase of animals, for example, a common non-mandatory rule is that such offspring are automatically encumbered and held by the creditor under the same terms.

48. Where the proceeds are monetary it makes little sense to oblige the creditor, after collection, to turn these over to the grantor. The usual non-mandatory rule is that the secured creditor may either apply cash proceeds to repayment of the secured obligation, or hold them in a separate account as additional security. This principle operates whether the money received is interest, a blended payment of interest and capital, or a stock dividend. Some States even permit the creditor to sell additional stock received as a dividend or to hold it (in the manner of the offspring of animals) as additional encumbered assets.

49. As for the right of disposition, there is great diversity in the manner States enact non-mandatory rules. In any case, the creditor cannot waste the encumbered asset. However, some States provide that the secured creditor may assign the secured obligation and the security right. That is, the creditor may transfer possession of the encumbered asset to the person to whom it has assigned the secured obligation. Some States also provide that the secured creditor may create a security right in the encumbered asset as security for its own debt ("re-pledge the encumbered property") as long as the grantor's right to obtain the assets upon payment of the secured obligation is not impaired. Often these re-pledge agreements are limited to stocks, bonds and other instruments held in a securities account, but in some States creditors may re-pledge tangible property such as diamonds, precious metals and works of art. By contrast, many States prohibit the secured creditor in possession from re-pledging the encumbered assets, even if it can do so on terms that do not impair the grantor's right to recover its property upon performance of the secured obligation.

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

however caused, it is entitled to add the cost of the insurance to the obligation secured.

51. This last rule is a particular example of a broader principle enacted as a non-mandatory rule in many States and recommended by this Guide. Reasonable expenses incurred by the secured creditor while discharging its custodial obligation to take reasonable care of the encumbered property are chargeable to the grantor and automatically added to the obligation secured (see A/CN.9/631, recommendation 108, subpara. (a)). Tax payments, repairer's bills and storage charges are examples of such reasonable expenses for which the grantor is ultimately liable.

(c) Grantor-in-possession security rights

52. A key policy objective of an effective secured transactions regime is to encourage responsible behaviour by the grantor that remains in possession of the encumbered assets. Maintaining the pre-default value of the encumbered assets is consistent with this objective. However, the policies underlying the non-mandatory rules for grantor-in-possession security are also aimed at maximizing the economic potential of the encumbered assets. In particular, encouraging the use and exploitation of encumbered assets is a way to facilitate revenue generation, and repayment of the secured obligation, by the grantor.

53. For this reason, most States provide that the grantor in possession does not surrender the general prerogatives of ownership simply because a security right has been created. Unless the parties otherwise agree, the grantor is entitled to use, mix, process and commingle the encumbered assets with other property in a manner that is reasonable and consistent with its nature and purpose and the purposes of the security agreement. In such a case, the secured creditor should have the right to monitor the conditions in which the encumbered asset is kept, used and processed by the grantor in possession and to inspect the asset at all reasonable times (see A/CN.9/631, recommendation 108, subpara. (b)). The duty to take care resting on the grantor in possession includes keeping the encumbered asset properly insured and ensuring that taxes are paid promptly. If the secured creditor incurs these expenses, even though the grantor remains in possession, the secured creditor has the right to reimbursement from the grantor and may add these expenses to the secured obligation.

54. If the encumbered assets consist of income-producing property in possession of the grantor, to the extent that the creditor's security right extends to the income or revenues generated by the asset, the grantor's duties may include maintaining adequate records and the reasonable rendering of accounts regarding the disposition and the handling of the proceeds derived from the encumbered assets. Specific obligations of the grantor in the case of intangible property (e.g. bank accounts, royalties from the use of patents, copyrights and trademarks), and particularly the grantor's right to payment in the form of receivables, are discussed in the next section.

55. Many States currently have a rule that protects fruits and revenues (as opposed to proceeds of disposition in the strict sense) from automatic re-encumbering under the security agreement. By contrast, this Guide provides that a security right extends to all proceeds generated by the encumbered asset. That is, unless otherwise agreed,

any increase in value or profit deriving from the encumbered assets in the grantor's possession is automatically subject to the security right, regardless of whether those additional assets are regarded as civil or natural fruits or as proceeds. To the extent that the fruits are in kind (e.g. increase in animals, stock dividends), the grantor may use and exploit them under the same terms and conditions as initially encumbered assets. Where they are agricultural products like milk, eggs and wool, most States provide that the grantor may sell them and that the secured creditor's rights may be claimed in the proceeds received. Where the civil fruits are revenues, the security right will extend to them as long as they remain identifiable. As a rule, however, the grantor will not only collect fruits and revenues, it will dispose of them in the ordinary course of business free of the security right.

56. The duty to preserve the encumbered asset normally means that the grantor in possession is responsible for loss or deterioration, whether caused by its fault or by fortuitous event. In principle, the grantor is not entitled to dispose of the encumbered assets without authorization of the secured creditor. If the grantor does so, the buyer will take the property subject to the security right. By way of exception, however, the grantor may dispose of the encumbered assets free of the security if they consist of inventory or consumer goods and they are sold in the seller's ordinary course of business (see A/CN.9/631, recommendation 87). Despite this limitation on disposition, because the grantor will normally retain the full use of the encumbered asset most States enact non-mandatory rules authorizing the grantor to create additional security rights charging already encumbered assets, the fruits and revenues they generate and the proceeds of their disposition.

(d) Possessory and non-possessory security rights

57. In addition to the rights specifically given to and obligations specifically imposed on secured creditors and grantors because of their possession of the encumbered assets, there are two common non-mandatory rules that speak to both secured creditor-in-possession (possessory) and grantor-in-possession (non-possessory) security. The first is a corollary of the idea that parties in possession should maintain the value of encumbered assets. If it should happen that the value of the encumbered assets were to decrease significantly for reasons that were unforeseeable at the time of the conclusion of the security agreement, and unrelated to any lack of attention by the party in possession, some States provide that the grantor will have to offer additional security to make up for the unexpected decrease in value. These States usually have other rules that restrict the capacity of secured creditors to over-collateralize (i.e. take a security right in assets of a significantly higher value than the value of the secured obligations). The assumption is that, in exchange for this limitation, the secured creditor should be able to require the grantor to offer further property in guarantee should the encumbered asset base fall precipitously. Moreover, this rule is often extended to normal deterioration of the value of the encumbered assets due to wear and tear or market conditions, whenever such deterioration reaches a significant percentage of the initial value of the encumbered assets.

58. A second common non-mandatory rule concerns the right of the secured creditor to assign both the obligation secured and the security right that attaches to it. Absent agreement to the contrary a secured creditor may freely assign the secured obligation and the accompanying security right (see, for example, art. 10 of the

United Nations Assignment Convention and A/CN.9/631, recommendation 26). Some States even provide that the secured creditor may do so even despite contractual limitations on assignment (see art. 9, para. 1, of the United Nations Assignment Convention and A/CN.9/631, recommendation 25). Where the secured creditor has possession, this implies that it may also transfer possession to the new secured creditor. In both cases, the assignee of the secured obligation cannot acquire greater rights as against the grantor or as against the encumbered asset than those that could be claimed by the assignor.

B. Asset-specific remarks

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

60. These rules contemplate the cases where the encumbered asset is tangible property. Nonetheless, in chapter III (Basic approaches to security) this Guide notes the importance of intangible property and, in particular, rights to payment as property that a grantor might encumber. While certain categories of intangible property are excluded from this Guide (i.e. securities, see A/CN.9/631, recommendation 4), many other types of intangible property are included: notably, contractual and non-contractual receivables, rights to payment of funds credited to a bank account and proceeds under an independent undertaking (see A/CN.9/631, recommendation 2, subpara. (a)).

61. The creation of a security right in a right to payment necessarily involves parties other than the grantor and the secured creditor, most obviously the debtor of the receivable. For this reason States have developed detailed rules to regulate the rights and obligations of the parties and of third parties, whether the right arises under a tangible (e.g. a negotiable instrument or a negotiable document) or under an intangible (e.g. a receivable, rights to payment of funds credited to a bank account, proceeds under an independent undertaking). Most of the rules relating to the relationship between the grantor and the secured creditor on the one hand, and the debtor on the obligation (what this Guide calls third-party obligors) on the other, are mandatory but some are non-mandatory. The rights and obligations of third-party obligors are discussed in detail in chapter IX.

62. This chapter focuses on the pre-default rights and obligations as between the assignor and the assignee. Consistent with the principle of party autonomy, most States take the position that the parties themselves should determine their mutual pre-default rights and obligations. Hence, the majority of the rules relating to these rights and obligations are non-mandatory. Articles 11-14 of the United Nations

Assignment Convention do, however, provide for a number of mandatory rules in the case of international assignments.

63. The basic principle in this field can be stated succinctly and is typically found in the national law of most States. It provides that, because the security agreement may refer to an ongoing relationship between the parties, unless they otherwise decide, they should be bound by their own practices and usages. This Guide adopts the idea that the agreement between the parties is the primary source of their mutual rights and obligations and that absent a contrary agreement, their own established practices and usages will also be binding on them (see A/CN.9/631, recommendation 110).

64. Some of the most important parts of the agreement between the assignor and the assignee relate to the representations that the assignor makes to the assignee. In the normal case, it is presumed that (a) the assignor has the right to assign the receivable; (b) the receivable has not been previously assigned; and (c) the debtor of the receivable does not have any defences or rights of set-off that can be set up against the assignor. In other words, if the assignor has doubts about any of these matters, it must explicitly mention these in the agreement or must explicitly state that it makes no representations to this effect. In all events, in parallel with the grantor's pre-default obligations in respect of tangible property, the assignor must take all reasonable steps necessary to preserve the value of the receivable. This means that it must continue to ensure that it retains the legal right to collect on the receivable. On the other hand, unless the assignor specifically warrants otherwise, it is presumed that the assignor does not warrant the actual capacity of the debtor of the receivable to pay. These various obligations are presented in the form of non-mandatory rules in the national law of most States and are recommended as such in this Guide (see A/CN.9/631, recommendation 111).

65. As the value of the assigned receivable consists of payment made by the debtor of the obligation, and as the debtor of the receivable is only obliged to pay the assignee if it actually knows of the assignee's rights (see A/CN.9/631, recommendations 114 and 115), it is important to maximize the capacity of the assignee to make the debtor aware of the assignment. For this reason, many States provide that either the assignor or the assignee may notify the debtor and give instructions about how payment is to be made. Nonetheless, in order to prevent conflicting instructions from being given, it is normally the case that thereafter, only the assignee may direct the debtor as to the manner and place of payment.

66. There may, of course, be situations where both the assignor and the assignee (or just one of them) do not wish the debtor of the receivable to know of the assignment. This desire may relate to particular features of the business in question or to general economic conditions. For this reason, States usually provide that the assignor and assignee may agree to postpone notifying the debtor of the receivable that the assignment has occurred until some later time. Until such notice is given, the debtor of the receivable will continue to pay the assignor according to the agreement between them or any subsequent payment instructions. Where a party (usually the assignee) is in breach of an obligation not to notify this should not prejudice the debtor of the receivable. The debtor may pay according to the instructions given and receive a discharge for amounts so paid (see A/CN.9/631, recommendation 116). Nonetheless, many States also provide that, unless the assignor and assignee otherwise agree, such a breach may give rise to liability for

any resulting damages. This Guide recommends that these general principles govern notification of the assignment to the debtor of the receivable (see A/CN.9/631, recommendation 112).

67. Because the right to payment is the actual object of the security, it is important to specify the effect of any payment made by the debtor of the receivable (whether to the assignor or the assignee) on their respective rights. Many States have enacted non-mandatory rules to govern the outcome of payments made in good faith that may not actually be made according to the intention of the assignor or assignee. For example, even if no notification of the assignment is given to the debtor of the receivable, payment might actually be made to or received by the assignee. Given the purpose of the security right in the receivable, it is more efficient that the assignee be entitled to keep the payment, applying it to a reduction of the assignor's obligation. Similarly, if payment is made to the assignor after the assignment has been made, and again regardless of whether the debtor of the receivable has received notice, the assignor should be required to remit the payment received to the assignee. Likewise, once notice has been given, if part of the payment obligation is to return property to the assignor, States often provide that this property should be handed over to the assignee. In all these cases, however, the rules adopted by many States are non-mandatory and, as a result, the assignor and assignee might provide for a different outcome in their agreement.

68. In the case of multiple assignments of a receivable, the debtor of the receivable may receive multiple notifications and may be uncertain as to which assignee has the best right to payment. Sometimes, the payment is made in good faith to an assignee that has a lower priority. In such cases, States usually provide that the assignee with prior rank should not be deprived of its rights to obtain payment and where the payment obligation involves the return of property to the assignor, to receive this property as well. In all cases, however, the assignee may only retain payment to the extent of its rights in the receivable, so that if the payment made by the debtor of the receivable is greater than the outstanding indebtedness of the assignor, the assignee must remit the excess to the person who is entitled to it (the next lower-ranking assignee or the assignor as the case may be). Consistent with its general approach to allocating pre-default rights and obligations as between assignor and assignee, this Guide recommends that these general principles govern cases where payment has been made in good faith to a person not actually entitled to receive it (see A/CN.9/631, recommendation 113).

69. These non-mandatory rules relating to pre-default rights and obligations of assignors and assignees of intangible property help to structure the relationship between them. In many ways, they paradigmatically reflect what non-mandatory rules are meant to accomplish, which is why they are explicitly stated in the national law of many States. For this reason also, this Guide recommends that they be included in any law relating to secured transactions so as to facilitate the efficient assignment and collection of receivables, while nonetheless permitting assignors and assignees to structure their own transactions differently so as to meet their own needs and wishes.

C. Recommendations

[Note to the Commission: The Commission may wish to note that, as document A/CN.9/631 includes a consolidated set of the recommendations of the draft legislative guide on secured transactions, the recommendations are not reproduced here. Once the recommendations are finalized, they will be reproduced at the end of each chapter.]

A/CN.9/631/Add.6 [Original: English]

**Note by the Secretariat on recommendations of the UNCITRAL draft Legislative
Guide on Secured Transactions, submitted to the Working Group on Security
Interests at its twelfth session**

ADDENDUM

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IX. Rights and obligations of third-party obligors

A. General remarks

1. Introduction

1. When the encumbered asset in a secured transaction consists of a right against a third party, the secured transaction is necessarily more complicated than when the encumbered asset is a simple object such as an item of equipment. Such rights against third parties may include “receivables”, “negotiable instruments”, “negotiable documents”, “rights to proceeds under an independent undertaking” and “rights to payment of funds credited to a bank account” (for the definitions of these terms, see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation). While these rights against third parties differ from each other in important ways, they have a critical feature in common: the value of the encumbered asset is the right to receive performance from a third-party obligor.

2. Depending on the nature of the right against a third party that is an encumbered asset, this Guide uses varying terminology to describe the third-party obligor. When the right is a receivable, for example, the third-party obligor is referred to as the “debtor of the receivable” and when the obligation is the right to proceeds under an independent undertaking, the third-party obligor is referred to as the “guarantor/issuer, confirmer or other nominated person” (for the definitions of these terms, see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation).

3. When the encumbered asset is a right against a third-party obligor, the secured transaction affects not only the grantor and the secured creditor but also the third-party obligor. Accordingly, laws typically provide appropriate protection against adverse effects on the third-party obligor, especially since that obligor is not a party to the secured transaction. On the other hand, those protections should not unduly burden the creation of security rights in rights against third-party obligors, since security rights facilitate the extension of credit by the secured creditor to the grantor, and thus by the grantor to the third-party obligor.

2. Effect of a security right on the obligations of a third-party obligor

(a) General

4. It is generally recognized that it would be inappropriate for a security right in a right to performance from a third-party obligor to change the nature or magnitude of the third-party obligor’s obligation. For example, article 15 of the United Nations Convention on the Assignment of Receivables in International Trade¹ (the “United Nations Assignment Convention”) permits no change in the obligation, other than the identity of the person to whom payment is owed (and, with some limitations, the address or account to which payment is to be made; see para. 8 below). This principle is equally applicable to third-party obligors in the case of rights other than receivables (such as the ones mentioned above).

5. When a negotiable instrument or negotiable document evidences the right against the third-party obligor, this principle is already reflected in law that is well developed in most States and that details the effect of an assignment on the

¹ United Nations publication, Sales No. E.04.V.14.

obligation of the obligor (“law governing a negotiable instrument” is broader than “negotiable instrument law”; see A/CN.9/631/Add.1, para. [...]). Thus, there is no need for secured transactions law to recreate those rules. Accordingly, this Guide generally defers to those bodies of law for effectuation of this principle. Similar protections exist under the law governing bank accounts and the law and practice governing independent undertakings, and this Guide defers to them as well.

(b) Effect of a security right on the obligations of the debtor of the receivable

6. While the effect of a security right on the obligor of a negotiable instrument or negotiable document is well developed in most States, this is not always the case with respect to a receivable that is the subject of a security right. Accordingly, this Guide addresses the effect of a security right on the obligation of the debtor of the receivable in some detail. For the most part, the Guide draws its policies from the analogous rules in the United Nations Assignment Convention.

7. In line with the approach of the United Nations Assignment Convention, the Guide covers not only security rights in receivables but also pure outright transfers and transfers by way of security (see A/CN.9/631, recommendation 3; for the definition of the terms “assignment”, “assignor” and “assignee” and related terms, see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation). Therefore, the discussion covers the debtor of the receivable in transactions in which the receivable has been transferred outright or utilized as an encumbered asset (in an outright assignment for security purposes or an assignment by way of security).

8. The United Nations Assignment Convention provides that, with few exceptions, the assignment of a receivable does not affect the rights and obligations of the debtor of the receivable without its consent. Permitted effects include only changes in the person, address or account to which the debtor of the receivable is to make payment. So as not to impose hardship on the debtor of the receivable that might result from the change in the person, address or account to which payment is to be made, though, the United Nations Assignment Convention prevents any instruction to the debtor of the receivable changing the person, address or account of payment, from changing the currency of payment or the State in which payment is to be made, unless the change is to the State in which the debtor of the receivable is located (see article 15 of the United Nations Assignment Convention and A/CN.9/631, recommendation 114).

9. When the assignment of a receivable is an outright transfer, the ownership of the right to receive performance from the debtor of the receivable has changed, but this does not necessarily mean that the party to whom payment is to be made will also change. This is because, in many cases, the assignee will enter into a servicing or similar arrangement with the assignor pursuant to which the latter obtains performance on behalf of the former.

10. Similarly, when the assignment of a receivable involves the creation of a security right, the assignment does not necessarily mean that the party to whom payment is to be made will change. In some cases, the arrangement between the assignor and the assignee will be that payments are to be made to the assignor (at least before any default by the assignor). In other cases, though, the arrangement will be that payments are to be made to the assignee.

11. In view of the fact that the obligation of the debtor of the receivable will be discharged only to the extent of payment to the right party (and may not be

discharged if payment is made to a different party), the debtor of the receivable has an obvious interest in knowing the identity of the party to whom payment is to be made. Thus, many legal systems protect the debtor of the receivable by providing that the debtor of the receivable is discharged by paying in accordance with the original contract until such time as it receives notification of the assignment and of any concomitant change in the person or address to which payment should be made. This principle provides important protection to the debtor of the receivable since it avoids the possibility that a payment will be found not to discharge the debtor of the receivable because the payment was made to a party that was no longer the creditor of the receivable, even though the debtor of the receivable was unaware of the change in the creditor of the receivable (see art. 17, para. 1, of the United Nations Assignment Convention and A/CN.9/631, recommendation 116, subpara. (a)).

12. Once the debtor of the receivable has been notified of the assignment and any new payment instructions, however, it is appropriate to require the debtor of the receivable to pay in accordance with the assignment and instructions (subject to the limitation described in para. 8 above, that the instructions may not change the currency of payment or the State in which payment is to be made unless the change is to the State in which the debtor of the receivable is located). This principle is critical to the economic viability of receivables financing. If the debtor of the receivable were to continue to be able to pay the assignor, this could deprive the assignee of the value of the assignment, especially when the assignor is in financial distress (see art. 17, para. 2, of the United Nations Assignment Convention and A/CN.9/631, recommendation 116, subpara. (b)).

13. As noted above, it would be inappropriate for an assignment of a receivable to change the nature or magnitude of the obligation of the debtor of the receivable. One implication of that principle is that the assignment should not, without the consent of the debtor of the receivable, deprive the debtor of the receivable of defences or rights of set-off that it could raise against the assignor in the absence of an assignment (see art. 18 of the United Nations Assignment Convention and A/CN.9/631, recommendation 117).

14. This principle should not, however, prevent the debtor of the receivable from agreeing that it may not raise against an assignee defences or rights of set-off that it could otherwise raise against the assignor. The effect of such an agreement is to confer on the receivable the same sort of “negotiability” that enables negotiable instruments to be enforced by “holders in due course” or “protected purchasers” without regard to defences or rights of set-off (for the meaning of the term “protected holder”, see, e.g., art. 29 of the United Nations Convention on International Bills of Exchange and International Promissory Notes² (the “UNCITRAL Bills and Notes Convention)). As the receivable could have been embodied in a promissory note or similar negotiable instrument with the agreement of the debtor of the receivable, there is no reason to prevent the debtor of the receivable from agreeing to the same result as would have been achieved by the use of a promissory note or similar negotiable instrument (see A/CN.9/631, recommendation 118, subpara. (a)). However, in most States, as in the UNCITRAL Bills and Notes Convention, there are certain defences, which can be raised even against a holder in due course or other protected purchaser (see, e.g., para. 1 of art. 30 of the UNCITRAL Bills and Notes Convention). The same result should follow in the context of agreeing not to raise defences against the assignee of a

² Ibid., Sales No. E.95.V.16.

receivable (see art. 19, para. 2, of the United Nations Assignment Convention and A/CN.9/631, recommendation 118, subpara. (b)).

15. When a receivable is created by contract, it is possible that the debtor of the receivable will agree with its creditor to modify the terms of the obligation. If such a receivable is the subject of an assignment, the effect of that modification on the rights of the assignee must be determined. If the modification occurs before the assignment, this means that the right assigned to the assignee is the original receivable as modified by the agreement of the debtor of the receivable and its creditor. If the modification occurs after the assignment, but before the debtor of the receivable has become aware that the creditor has assigned the receivable, it is understandable that the debtor of the receivable would believe that the agreement of modification was entered into with the creditor of the receivable and, thus, would be effective. Accordingly, legal systems generally provide that such a modification is effective as against the assignee (see, e.g., art. 20, para. 1, of the United Nations Assignment Convention and A/CN.9/631, recommendation 119, subpara. (a)).

16. If the agreement to modify the terms of the receivable is entered into between the debtor of the receivable and the assignor after the assignment has already occurred and after the debtor has been notified of it, such a modification is usually not effective unless the assignee consents to it. The reason is that, at this point, the assignee's right in the receivable has already been established and such a modification would change the assignee's rights without its consent. Some legal systems, however, provide limited exceptions to this rule of ineffectiveness. For example, if the right to be paid on the receivable has not yet been fully earned by performance and the original contract provides for the possibility of modification, the modification may be effective against the assignee. In some cases, such as when the original contract governs a long-term relationship between the debtor and the creditor of the receivable, and the relationship is of the sort that is frequently the subject of modification, the assignee might anticipate that reasonable modifications might be made in the ordinary course of business even after assignment. As a result, some legal systems provide that a modification to which a reasonable assignee would consent is effective against the assignee, even if made after the debtor of the receivable is aware of the assignment, so long as the receivable has not yet been fully earned by performance (see art. 20, para. 2, of the United Nations Assignment Convention and A/CN.9/631, recommendation 119, subpara. (b)).

(c) Effect of a security right on the obligations of the obligor on a negotiable instrument

17. In most States, the law governing negotiable instruments is well developed and contains clear rules as to the effect of a transfer of an instrument on the obligations of parties to the instrument. As a general matter, those rules continue to apply in the context of security rights in negotiable instruments (see A/CN.9/631, recommendation 121).

18. Thus, for example, the secured creditor is not able to collect on the negotiable instrument except in accordance with the terms of the negotiable instrument. Even if the grantor has defaulted on its obligation to the secured creditor, the secured creditor cannot enforce the negotiable instrument against an obligor under the negotiable instrument except when payment is due under the negotiable instrument. For example, if a negotiable instrument is payable only at maturity, a secured

creditor is not permitted to require payment on the negotiable instrument prior to its maturity, except as set forth in the terms of the negotiable instrument itself.

19. In addition, the secured creditor, unless otherwise agreed by the obligor, cannot collect on the negotiable instrument except in accordance with the law governing negotiable instruments. Typically, as a matter of the law governing negotiable instruments, for the secured creditor to collect on the negotiable instrument, the secured creditor must be a holder of the negotiable instrument by being in possession of it with any necessary endorsement. Otherwise, the obligor will not be assured of obtaining a discharge on the negotiable instrument by paying the secured creditor. Accordingly, the obligor is often permitted to insist, under the law governing negotiable instruments, on paying only the holder of the negotiable instrument. However, in some legal systems, a transferee of an instrument from a holder can enforce the instrument if the transferee has possession.

20. Under the law governing negotiable instruments, the secured creditor may or may not be subject to the claims and defences of an obligor on the instrument. If the secured creditor is a protected holder of the negotiable instrument, the secured creditor is entitled to enforce the negotiable instrument free of certain claims and defences of the obligor. These claims and defences are the so-called “personal” claims and defences, such as normal contract claims and defences, which the obligor could have asserted against the prior holder. However, the secured creditor, even as a protected purchaser, remains subject to so-called “real” defences of the obligor, such as lack of legal capacity, fraud in the inducement or discharge in insolvency proceedings.

21. If the secured creditor is a holder of the negotiable instrument but not a protected holder, the secured creditor, while entitled to collect on the negotiable instrument, is usually subject to the claims and defences that the obligor could have asserted against a prior holder of the negotiable instrument. These claims and defences include all “personal” claims and defences unless the party liable on the negotiable instrument has effectively waived its right to assert such claims and defences in the negotiable instrument itself or by separate agreement with the secured creditor.

(d) Effect of a security right on the obligations of the depositary bank

22. In legal systems in which a security right may be created in a right to payment of funds credited to a bank account only with the consent of the depositary bank, the bank has no duty to give its consent. In legal systems where the depositary bank’s consent to the creation of the security right is not required, the rights and obligations of the depositary bank may nonetheless not be affected without its consent (see A/CN.9/631, recommendation 122, subpara. (a)). In both cases, the reason lies in the critical role of banks in the payment system and the need to avoid interfering with banking law and practice.

23. The reason for not imposing duties on a depositary bank or changing the rights and duties of the depositary bank without its consent is that imposing such duties without the bank’s consent may subject the bank to undue risks that it is not in a position to manage without having appropriate safeguards in place. The depositary bank is subject to significant operational risks, with funds being debited or credited to bank accounts on a daily basis, often with credits being made on a provisional basis, and sometimes involving other transactions with its customers. These risks are compounded by the legal risk to the depositary bank of failing to comply with

laws dealing with negotiable instruments, credit transfers and other payment system rules in its day-to-day operations, as well as the risk of not complying with certain duties imposed on the depositary bank by other law, such as laws requiring it to maintain the confidentiality of its dealings with its customers. In addition, the depositary bank is typically subject to regulatory risk under laws and regulations of the State designed to ensure the safety and soundness of the depositary bank. Finally, the depositary bank is subject to reputational risk in choosing the customers with which it agrees to enter into transactions.

24. The experience in those States where the depositary bank's consent to new or changed duties is required suggests that the parties are often able to negotiate satisfactory arrangements so that the depositary bank is comfortable that it is managing the risks involved given the nature of the transaction and the bank's customer.

25. In particular to avoid any interference with the depositary bank's rights of set-off against the account holder, legal systems that permit the depositary bank to obtain a security right in the right to payment of funds credited to a bank account held with the bank, provide that the bank maintains any rights of set-off it might have under law other than the secured transactions law (see A/CN.9/631, recommendation 122, subpara. (b)).

26. The same principles apply with respect to the third-party effectiveness, priority and enforcement of a security right in a right to payment of funds credited to a bank account. For example, in legal systems that refer to the notion of "control" with respect to the third-party effectiveness of a security right in a right to payment of funds credited to a bank account, there are appropriate rules to safeguard the confidentiality of the relationship of a bank and its client (for the definition of "control", see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation). Such rules provide, for example, that the bank has no obligation to respond to requests for information about whether a control agreement exists or whether the account holder retains the right to dispose of funds credited to its bank account (see A/CN.9/631, recommendation 123, subpara. (b)).

27. In legal systems in which the security right in a bank account is made effective against third parties by registration of a notice in a public registry or by acknowledgment on the part of the depositary bank, the notice or acknowledgement may or may not impose duties on the depositary bank to follow instructions from the secured creditor as to the funds in the account. If such duties are not imposed on the depositary bank under the applicable laws of a particular State, the secured creditor's right to obtain the funds in the bank account upon enforcement of the security right would usually depend upon whether the customer-grantor has instructed the depositary bank to follow the secured creditor's instructions as to the funds or the depositary bank has agreed with the secured creditor to do so. In the absence of such instructions or agreement, the secured creditor may need to enforce the security right in the bank account by using judicial process to obtain a court order requiring the depositary bank to turn over the funds credited to the bank account to the secured creditor.

28. In legal systems in which the depositary bank may negotiate its favourable priority position with the bank account holder and its creditors, the bank has no duty to subordinate its rights to the security right of another creditor of the account holder. Even if, in order to facilitate the creation, effectiveness against third parties, priority and enforcement of a security right in a right to payment of funds credited

to a bank account, the secured creditor is willing to become the depositary bank's customer with respect to the bank account, the depositary bank has no duty to accept the secured creditor as the bank's customer.

(e) Effect of a security right on the obligations of the guarantor/issuer, confirmer or nominated person under an independent undertaking

29. The rights and duties of the guarantor/issuer, confirmer or nominated person with respect to an independent undertaking are quite well developed under the law and practice governing independent undertakings (for the definitions of these terms, see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation). This highly developed law and practice has facilitated the usefulness of independent undertakings, particularly in international trade. Accordingly, the development of secured transactions law with respect to independent undertakings should take great care to avoid interfering with these useful commercial mechanisms.

30. In order to avoid such interference, it is helpful to distinguish between the independent undertaking itself and the right of a beneficiary of such an undertaking to receive a payment (or another item of value) due from the guarantor/issuer or nominated person. While providing for a security right in the former without interference with the usefulness of the independent undertaking is a delicate task, a security right in the latter carries fewer risks because it relates only to the right of the beneficiary and would not have an effect on the guarantor/issuer, confirmer or a nominated person.

31. This Guide recommends rules facilitating the use of the right to proceeds under an independent undertaking as collateral, but with strict conditions designed to avoid negative effects on guarantors/issuers, confirmers or nominated persons (and, thus, on the usefulness of independent undertakings).

32. A cardinal principle is that a secured creditor's rights in proceeds under an independent undertaking should be subject to the rights, under the law and practice governing independent undertakings, of the guarantor/issuer, confirmer or nominated person. Similarly, to avoid undermining the independence of the undertaking, a transferee-beneficiary normally takes the undertaking without being affected by a security right in the proceeds under the independent undertaking of a transferor. For the same reason, if the guarantor/issuer, confirmer or nominated person has a security right in the proceeds under an independent undertaking, their independent rights are not adversely affected (see A/CN.9/631, recommendation 24).

33. Equally important is the principle that a guarantor/issuer, confirmer or nominated person should not be obligated to pay any person other than a confirmer, a nominated person, a named beneficiary, an acknowledged transferee of the independent undertaking or an acknowledged assignee of the proceeds under an independent undertaking (see A/CN.9/631, recommendation 125). If the guarantor/issuer, confirmer or nominated person acknowledges a secured creditor or transferee of the proceeds under an independent undertaking, the secured creditor or transferee may enforce its rights against the person that made the acknowledgement, since the independence of the undertaking is not compromised (see A/CN.9/631, recommendation 126).

(f) Effect of a security right on the obligations of the issuer or other obligor under a negotiable document

34. In most States, the law governing negotiable documents is well developed and contains clear rules as to the effect of a transfer of a document on the obligations of parties to the document. As a general matter, those rules continue to apply in the context of security rights in negotiable documents (see A/CN.9/631, recommendation 127).

35. This means, inter alia, that the right of a secured creditor to enforce a security right in a negotiable document and, thus, in the goods covered by it, is limited by the law governing negotiable documents. The limit is that the goods covered by the negotiable document are in the hands of the issuer or other obligor under that document, and the issuer's or other obligor's obligation to deliver the goods typically runs only to the consignee or to any subsequent holder. Thus, if the negotiable document was not transferred to the secured creditor in accordance with the law governing negotiable documents, the issuer or other obligor will have no obligation to deliver the goods to the secured creditor. In such a case, the secured creditor may need to have a court or other tribunal order the transfer of the document to the secured creditor (or to a person designated by the secured creditor), or otherwise order the issuer or other obligor to deliver the goods to the secured creditor or other person designated by the secured creditor.

B. Recommendations

[Note to the Commission: The Commission may wish to note that, as document A/CN.9/631 includes a consolidated set of the recommendations of the draft legislative guide on secured transactions, the recommendations are not reproduced here. Once the recommendations are finalized, they will be reproduced at the end of each chapter.]

A/CN.9/631/Add.7 [Original: English]**Note by the Secretariat on recommendations of the UNCITRAL draft Legislative Guide on Secured Transactions, submitted to the Working Group on Security Interests at its twelfth session****ADDENDUM****CONTENTS**

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X. Post-default rights

A. General remarks

1. Introduction

1. Parties to any agreement usually expect each other voluntarily to perform all their obligations, whether owed between themselves or to third parties, and whether these obligations arise by contract or by operation of law. Only where performance is not forthcoming do parties contemplate compulsory enforcement through a judicial procedure. Typically, States carefully develop enforcement regimes for ordinary civil actions that balance the rights of debtors, creditors and third parties. In most States these regimes require a creditor seeking to enforce performance to

bring a court action to have the claim recognized and then to have the debtor's property seized and sold under the supervision of a public official. From the amount generated by the sale, the judgement creditor will receive payment of its outstanding claim against the judgement debtor.

2. Parties to a security agreement have similar expectations of each other. A secured creditor usually presumes that a grantor will perform its obligations voluntarily. Likewise, a grantor will typically expect the secured creditor to fulfil the obligations it has undertaken. Both enter the transaction fully expecting and intending to meet their obligations to each other. Yet both also recognize that there will be times when they may not be able to do so. Sometimes the secured creditor will fail to make a promised payment, or to return property to a grantor when an agreed condition for doing so occurs. In such cases, depending on the nature of the agreement between them, the grantor will normally apply to the court for relief. Most often, however, it is the grantor that finds itself incapable of performing as promised (that is, will not repay the credit according to the terms of the agreement). The failure will sometimes flow from reasons beyond the grantor's control, such as an economic downturn in an industry or more general economic conditions. Sometimes it may result from defaults by the grantor's own debtors. Sometimes the grantor cannot perform owing to business misjudgements, or as a consequence of poor management.

3. Whatever the reason, even after one or more payments have been missed, it is in the interest of both parties to a security agreement, and to third parties generally, that the grantor attempt to make up these payments and continue voluntarily to perform the promised obligation. Compulsory enforcement proceedings are always less efficient than voluntary performance, since (a) they are costly; (b) they take time; (c) the outcome is not always certain; and (d) the longer-term consequences for grantors and third parties are often devastating. This is why many States actively encourage parties to a security agreement to take steps during its currency to avoid a failure of performance that would lead to compulsory enforcement. Moreover, this is why secured creditors often will closely monitor their grantors' business activities. For example, they will periodically review account books, inspect the encumbered assets and communicate with those grantors that show signs of financial difficulty. Grantors having trouble meeting their obligations generally will cooperate with their secured creditors to work out ways to forestall or to overcome their difficulties. In some cases, a grantor may request a secured creditor's assistance in developing a new business plan. In other cases, the grantor and an individual creditor, or the grantor and its whole group of creditors working together, may attempt to readjust aspects of their agreements.

4. There are many types of debt readjustment agreements. Sometimes the parties enter into a "composition" or "work-out" arrangement that extends the time for payment, otherwise modifies the grantor's obligation, or adds or reduces encumbered assets that secure these obligations. Negotiations to reach a composition agreement take place against a background of two main factors: (a) the secured creditor's right to enforce its security rights in the encumbered assets if the grantor defaults on its secured obligation; and (b) the possibility that insolvency proceedings will be initiated by or against the grantor.

5. Nevertheless, despite the best efforts of grantors and secured creditors to avoid compulsory enforcement proceedings, they will occasionally be unavoidable. One of

the key issues for States enacting secured transactions regimes is, consequently, to decide the contours of a creditor's post-default rights. More specifically, the question is what modifications, if any, States should make to the normal rules that apply to the enforcement of claims when developing rules to govern how security rights can be enforced when the grantor fails to perform the secured obligation.

6. At the heart of a secured transactions regime is the right of the secured creditor to look to the amount that can be realized upon the sale of the encumbered assets to satisfy the secured obligation. Enforcement mechanisms that allow creditors accurately to predict the time and cost involved in disposing of the encumbered assets and the likely proceeds received from the enforcement process will have a significant impact on the availability and the cost of credit. A secured transactions regime should, therefore, provide efficient, economical and predictable procedural and substantive rules for the enforcement of a security right after a grantor has defaulted. At the same time, because enforcement will directly affect the rights of third parties, the rules should provide reasonable safeguards for the rights of the grantor, other persons with a right in the encumbered assets and the grantor's other creditors.

7. All interested parties benefit from maximizing the amount achieved from the sale of the encumbered assets. The secured creditor benefits by the potential reduction of any deficiency that the grantor may owe as an unsecured obligation after application of the proceeds of enforcement to the outstanding secured obligation. At the same time, the grantor and the grantor's other creditors benefit from a smaller deficiency or a larger surplus.

8. This chapter examines the secured creditor's right to enforce its security right if the grantor fails to perform ("defaults on") the secured obligation prior to the institution of insolvency proceedings or, with the permission of the appropriate body, during insolvency (see chapter XI). In section A.2 of the chapter, the general principles guiding default and enforcement are discussed. Section A.3 reviews the procedural steps that a secured creditor may be required to follow prior to exercising its remedies and sets out the grantor's post-default rights. The different recourses typically available to secured creditors are examined in section A.4. In section A.5 the effects of enforcement on the grantor, the secured creditor and third parties are considered.

9. The enforcement of security rights in receivables, negotiable instruments, funds credited to a bank account and proceeds under an independent undertaking does not fit easily into the general procedures for enforcement against tangible property (for the definitions of those terms, see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation). As a result, many States have particular rules dealing with enforcement against intangible property, receivables and various other rights to payment. These special situations are discussed in sections B.1-B.5 of this chapter. In addition, because tangible property may sometimes be attached to other movable or immovable property, or may be commingled or manufactured, it is necessary to adjust the general regime to govern enforcement of attachments and masses or products. The types of adjustment that may be necessary for effective enforcement against attachments, masses or products are discussed in sections B.6-B.9. The chapter concludes, in section C, with a series of recommendations.

2. General principles of enforcement

(a) General

10. As noted in the preceding section, it is in everyone's interest that the grantor voluntarily performs its promised obligation. For this reason, when performance is not forthcoming, the secured creditor and the grantor normally will attempt to conclude an agreement that obviates the need to commence compulsory enforcement proceedings. Seldom will a grantor be unaware that it is not performing its obligations and even more rarely, if ever, will the grantor learn for the first time that it is in default by means of a formal indication to this effect from the secured creditor. Indeed, in the latter case, enforcement proceedings usually do not follow since the failure of performance will almost always have been due to inadvertence rather than an inability or unwillingness to pay. Still, compulsory enforcement will sometimes become necessary. When it does, a number of basic principles guide States in elaborating the post-default rights and obligations of secured creditors and grantors.

(b) Requirement of a default prior to enforcement

11. A security right secures the performance of a grantor's (or, in the case of a third-party grantor, the debtor's) obligation to the secured creditor. In the standard case, therefore, the security right becomes enforceable as soon as the grantor fails to pay the secured obligation. There are, however, a number of other "events of default" that are typically set out in the security agreement. Any one of these events, unless waived by the secured creditor, is sufficient to constitute a default, thereby permitting compulsory enforcement of the security right. In other words, the parties' agreement and the general law of obligations will determine whether the grantor is in default and when enforcement proceedings may be commenced. This general law of obligations usually will also determine whether a formal notice of default must be given to the debtor and, if so, what the content of that notice will be.

12. Occasionally, default occurs not because a payment has been missed, but because another creditor either seizes the encumbered assets under a judgement or seeks to enforce its own security right. Many States provide that, apart from any stipulation in the security agreement, the seizure of encumbered assets by any other creditor constitutes a default under all security agreements that encumber the seized property. The rationale is based on efficiency. Since the encumbered asset is the creditor's guarantee of payment, whenever that asset is subject to judicial process, the secured creditor should be enabled to intervene to protect its rights. In these cases, procedural law will often give these other creditors the right to force the disposition of encumbered assets. The secured creditor will look to this same procedural law for rules on intervening in these judicial actions and enforcement proceedings in order to protect its rights and its priority.

13. Typically, States provide that a secured creditor with priority will be able to substitute its own enforcement process for that of a subordinate secured creditor should it so choose. This rule follows because the two secured creditors will be enforcing similar rights under the same security regime and the enforcement rights of these creditors should, therefore, be determined by their respective priority. By contrast, in some States, once enforcement of a judgement claim has commenced, the secured creditor may not intervene to enforce its rights under the security

agreement. This approach is usually followed in States where a judicial sale purges all rights, including security rights, from the property sold. The assumption is that because the judicial sale enables the purchaser to acquire a clean title, it will produce the highest enforcement value (see paras. 20-23 below). In other States, however, where a secured creditor has rights in some or all of the property under seizure by a judgement creditor, the secured creditor is permitted to raise the seizure and enforce its security rights by any means available to it. This approach is usually found in States where a regular judicial sale in execution does not purge security rights. The assumption is that since security rights will not be purged, a higher price of disposition is more likely to be realized when the enforcement process leads to the purchaser obtaining the cleanest title (see paras. 61 and 62 below).

(c) Judicial supervision of enforcement

14. Generally speaking, when a grantor is in default and attempts to compose the obligations have failed, both parties are reconciled to the need for compulsory enforcement against the encumbered assets. In some cases, however, grantors will contest either the secured creditor's claim that they are in default, or the secured creditor's calculation of the amount owed as a result of the default. As a matter of public policy, States invariably provide that grantors are always entitled to request courts to confirm, reject, modify or otherwise control the exercise of a creditor's enforcement rights.

15. The point is not to burden secured creditors with unnecessary judicial procedures, but rather to enable grantors and other interested parties to ensure respect for mandatory post-default procedures (see A/CN.9/631, recommendation 141). Consequently, to ensure that grantor challenges to enforcement can be dealt with in a time- and cost-efficient manner, many States replace the normal rules of civil procedure with expedited judicial proceedings in these cases (see A/CN.9/631, recommendation 137). For example, grantors and other interested parties may be given only a limited time within which to make a claim or raise a defence. Other States permit grantors to challenge the secured creditor on these issues even after enforcement has commenced, or at the time proceeds of enforcement are distributed, or when the secured creditor seeks to collect any deficiency. Still other States permit grantors to obtain not only compensatory damages, but also punitive damages, should it be shown that the secured creditor either had no right to enforce, or enforced for an amount greater than that actually owed.

16. Furthermore, because all such challenges will delay enforcement and add to its cost, many States also build safeguards into the process to discourage grantors from making unfounded claims. These include procedural mechanisms, such as adding the costs of the proceedings to the secured obligation in the event that they are unsuccessful, or requiring affidavits from grantors and their counsel as a prerequisite to launching such proceedings. Some States also permit secured creditors to seek damages against grantors that bring frivolous proceedings, or fail to comply with their obligations, and to add these damages to the secured obligation. This Guide recommends that ordinary damages be available if the grantor fails to comply with any of its post-default obligations (see A/CN.9/631, recommendation 133; the same rule applies to the secured creditor).

(d) Good faith and commercial reasonableness

17. Enforcement of a security right has serious consequences for grantors, debtors and interested third parties. For this reason, many States impose, as a general and overriding obligation of secured creditors, a specific duty to act in good faith and follow commercially reasonable standards when enforcing their rights. Because of the importance of this obligation, these States also provide that at no time may the secured creditor and the grantor waive or vary it (see A/CN.9/631, recommendations 128 and 129). Moreover, as noted, a secured creditor that does not comply with enforcement obligations imposed on it will be liable for any damages caused to the persons injured by its failure. For example, if a secured creditor does not act in a commercially reasonable manner in disposing of the encumbered assets and that results in the secured creditor obtaining a smaller amount than a commercially reasonable disposition would have produced, the secured creditor will owe damages to any person harmed by that differential (see A/CN.9/631, recommendation 133).

(e) Freedom of parties to agree to the enforcement procedure

18. States generally impose very few pre-default obligations on parties to a security agreement (see chapter VIII, Rights and obligations of the parties). A key issue in the post-default enforcement context is, consequently, whether a similar policy should prevail. In other words, the issue is to what extent the secured creditor and the grantor should be permitted to modify either the statutory framework for enforcing security rights or their respective contractual rights as set out in the security agreement. Some States consider the enforcement procedure to be part of mandatory law that the parties cannot modify by agreement. In other States, the parties are allowed to modify the statutory framework for enforcement as long as public policy, priority, and third-party rights (in particular in the case of insolvency) are not affected. In yet other States, emphasis is placed on efficient enforcement mechanisms in which judicial enforcement is not the exclusive or the primary procedure. Hence, even if there are limits on the extent to which the secured creditor and the grantor may agree to modify the statutory framework in their security agreement (because the freedom to vary an enforcement obligation may be the subject of abuse at the time of conclusion of the security agreement), these States permit them to waive or modify their rights under the security agreement after a default occurs.

19. States that permit parties to waive their legal or contractual post-default rights by agreement nonetheless impose a number of restrictions on their capacity to do so. For example, they invariably do not permit waiver of the creditor's obligation to act in good faith and in a reasonably commercial manner (see A/CN.9/631, recommendation 129). As for other obligations, many States distinguish between the rights of the grantor and those of the secured creditor. In some States, the grantor may waive or agree to vary the secured creditor's post-default obligations only after a default has occurred. Allowing a waiver after default often enables the grantor and the secured creditor to "work out" in a non-adversarial way a disposition of the encumbered assets in a manner that maximizes the amount that can be realized for the benefit of the secured creditor, the grantor and the other creditors of the grantor (see A/CN.9/631, recommendation 130). These same States usually also permit a secured creditor to waive a grantor's obligations at any time (either prior to or after

default) on the assumption that there is little risk of abusive terms being imposed by the grantor at the time the credit is being extended (see A/CN.9/631, recommendation 131).

(f) Judicial and extrajudicial enforcement

20. As a general principle of debtor-creditor law, most States require claims to be enforced by judicial procedures. Creditors must sue their debtors, obtain judgement and then resort to other public officials or authorities (e.g. bailiffs, notaries or the police) to enforce the judgement. In order to protect the grantor and other parties with rights in the encumbered assets, some States impose a similar obligation on secured creditors, requiring them to resort exclusively to the courts or other governmental authorities to enforce their security rights. However, as court proceedings can be slow and costly, often they are less likely to produce the highest possible amount upon the disposition of the property being sold. In addition, because the expenses involved in enforcement will be factored into the cost of the financing transaction, inefficient processes will have a negative impact on the availability and the cost of credit.

21. To facilitate secured credit, some States require only a minimal prior intervention by officials such as courts, bailiffs or the police in the enforcement process. For example, the secured creditor may be required to apply to a court for an order of repossession, which the court will issue without a hearing. In other cases, once the secured creditor is in possession of the asset, it may sell it directly without court intervention as long as it hires a certified bailiff to manage the process according to prescribed procedures. The justification for a less formal approach lies in the fact that having the secured creditor or a trusted third party take control and dispose of the assets will often be more flexible, quicker and less costly than a State-controlled process. A properly designed system can provide protection to the grantor and other persons with an interest in maximizing the amount that will be achieved from the sale of the encumbered assets while at the same time providing an efficient system for realizing the encumbered assets. Moreover, the knowledge that judicial intervention is readily available is often sufficient to create incentives for cooperative and reasonable behaviour that obviates the need to actually resort to the courts.

22. In some States, the secured creditor is not required to use the courts or other governmental authorities for any enforcement purposes, but is entitled to make exclusive use of extrajudicial procedures. These States usually impose, in these cases, a number of mandatory rules relating to, for example, a notice of default or notice of intended disposition, the obligation to act in good faith and in a commercially reasonable manner, and the obligation to account to the grantor for the proceeds of disposition. In addition, they do not permit the secured creditor to take possession of the encumbered assets out of court if such enforcement would result in a disturbance of the public order. The purpose and effect of these requirements is to provide for flexibility in the methods used to dispose of the encumbered assets so as to achieve an economically efficient enforcement process, while at the same time protecting the grantor and other interested parties against actions taken by the secured creditor that, in the commercial context, are not reasonable. This Guide recommends that, in order to maximize flexibility in enforcement and thereby to obtain the highest possible price upon disposition, creditors should have the option

of proceeding either judicially or extra judicially when enforcing their security rights (see A/CN.9/631, recommendation 136). In any event, in States that permit extrajudicial enforcement, the courts are always available to ensure that legitimate claims and defences of the grantor and other parties with rights in the encumbered assets are recognized and protected (see A/CN.9/631, recommendation 141).

23. Even in States where a secured creditor is permitted to act without official intervention, it is normally also entitled to enforce its security right through the courts. Moreover, because a security right is granted in order to enhance the likelihood of a creditor receiving payment of the secured obligation, post-default enforcement of the security right should not preclude a secured creditor from attempting to enforce the secured obligation by ordinary judicial process (see A/CN.9/631, recommendation 139). There are a number of reasons why a secured creditor might choose either of these options over extrajudicial enforcement. The secured creditor may wish to avoid the risk of having its actions challenged after the fact, or it may conclude that it will have to apply for a judicial proceeding anyway in order to recover an anticipated deficiency. Many States actually encourage secured creditors to use the courts by providing for less costly and more expeditious enforcement proceedings. They may, for example, permit enforcement through a process involving only affidavit evidence. They may also provide that the hearing must be held, challenges disposed of, and a decision rendered within a very short time period (e.g. 72 hours). Some States go even further and permit a secured creditor that has obtained judgement to dispose of the encumbered assets without having to use the official seizure and sale process. Finally, most States provide that these recourses are cumulative. A secured creditor that elects to pursue a judicial remedy may change its mind and later pursue an extrajudicial remedy to enforce its security rights to the extent exercise of a right does not make the exercise of another right impossible (see A/CN.9/631, recommendation 138).

(g) Scope of a secured creditor's enforceable rights

24. A general creditor that obtains judgement may enforce the judgement against all the debtor's property that procedural law allows to be seized. This generally will include all the debtor's property rights of whatever kind. If the debtor has only a limited right in property, only that limited right (e.g. a usufruct) may be seized and sold. Similarly, if a debtor's rights in property are limited by a term or a condition, the enforcement against the property will be likewise limited. The purchaser at the judicial sale may only acquire the property subject to the same term or condition.

25. Unlike the case of ordinary enforcement of judgements, the enforcement of security rights is subjected to an important additional limitation. A secured creditor may only proceed against the assets actually encumbered by its security right and not as against the grantor's entire estate (the secured creditor may, of course, proceed as an unsecured creditor against the grantor for claims beyond the amount of the secured obligation). Within this additional constraint, principles similar to those governing enforcement in general apply to the enforcement of a security right. The secured creditor may only enforce the security right against the particular rights that the grantor actually has in the encumbered assets. So, for example, if a grantor's ability to sell or otherwise dispose of, lease or license an encumbered asset is limited, the secured creditor's enforcement may not override those restrictions. This means that, if a grantor holds assets subject to a trademark licence, the security right

would encompass only the grantor's right subject to enforceable terms in the trademark licence and would not give the secured creditor any general right to use or dispose of the trademark.

[Note to the Commission: The Commission may wish to consider whether the order of recommendations 128-141 might be modified so as to more closely track the explanation provided in these commentaries.]

3. Procedural steps preceding enforcement and the rights of the grantor

(a) General

26. States are required to develop procedural mechanisms to facilitate effective and efficient enforcement by the secured creditor and protection of the rights of the grantor and third parties with a right in the encumbered assets, regardless of whether the secured creditor (a) must obtain a judgement in the regular way, have a public official seize the encumbered assets and sell them at a public auction; or (b) has access to an expedited judicial remedy to have the debtor's default acknowledged, and is then able to proceed immediately to have a public official seize and sell the encumbered assets; or (c) is entitled to enforce its rights without judicial process. These procedural mechanisms are meant to ensure a balance between competing rights after default but prior to the effective exercise of the secured creditor's remedies. For this reason, States usually provide that these procedural mechanisms apply regardless of the particular remedy selected by the secured creditor. This means that they would apply whether the secured creditor (a) seizes and sells the encumbered assets privately, appropriating the proceeds of sale to the repayment of the outstanding obligation; (b) accepts the encumbered asset in payment of the secured obligation; or (c) takes possession of a business, operating it to pay the secured obligation.

(b) Notice of intended extrajudicial enforcement

27. Where a secured creditor elects to enforce the security agreement by bringing before the courts an ordinary action against the grantor with respect to the secured obligation, the normal rules of civil procedure (including those relating to notice of default and the opportunity for a hearing on the merits) will apply to both the judicial action itself and the post-judgement enforcement process. Usually, however, these rules only apply directly to the formal processes of courts. This is why States that permit extrajudicial enforcement typically enact separate rules governing extrajudicial enforcement. These rules are designed to ensure that the rights of affected parties are adequately protected while at the same time providing for a maximum of flexibility in the enforcement process. Invariably, States require that secured creditors give a notice of their intention to dispose of the encumbered assets to all persons that may be affected by the disposition (e.g. the debtor, a third-party grantor and any person with rights in the encumbered assets).

28. The acknowledged need for a notice of extrajudicial disposition confronts States with a fundamental policy choice. In some States, a secured creditor must give an advance notice of its intention to pursue extrajudicial enforcement even before seeking to obtain possession of the encumbered assets. That is, the creditor must provide the grantor (and usually also third parties with a right in the encumbered assets) a written notice specifying the default, the encumbered assets,

the creditor's intention to demand possession of the assets, the delay within which the grantor must either remedy the default or surrender the assets (typically 15-20 days) and, frequently, also the particular remedy that the creditor intends to follow in disposing of them. In other States, the timing of the notice is deferred and its substantive content is often less detailed. For example, in these States the secured creditor is not required to give prior notice of its intention to take possession, but is entitled to immediate possession of the encumbered assets at the same time that it gives formal notice of default to the grantor. Once in possession, however, the secured creditor usually may not dispose of the assets without giving the grantor and interested third parties an advance notice (typically 15-20 days) of the mode and manner of disposition that it proposes to follow if the grantor fails to remedy the default in the interim.

29. There are advantages and disadvantages to both of these approaches. The principal advantage of a regime that requires a prior notice of the secured creditor's intention to enforce and take possession of the encumbered assets is that it alerts the grantor and debtor to the need to protect their rights in the encumbered assets (invariably the debtor will be aware of its default but the third-party grantor may not be). This might involve, for example, challenging the enforcement, curing the debtor's default or seeking potential buyers for the encumbered assets. Notice to other interested parties allows them to monitor subsequent enforcement by the secured creditor, to contest the enforcement, or, if it is in their interest, to cure the default and, if they are secured creditors whose rights have priority (and the grantor is in default towards them as well), to participate in or take control of the enforcement process. The disadvantages of this type of notice include its cost, the fact that the secured creditor may have to elect a remedy before close inspection of the encumbered assets, the opportunity it provides an uncooperative grantor to remove the encumbered assets from the creditor's reach, and the possibility that other creditors will race to assert claims against the grantor's business and interfere with the disposition process. Moreover, unless formal and substantive requirements with respect to notices are clear and simple, there is a risk of "technical" non-compliance that will then generate litigation and its attendant cost and delay.

30. The advantage of a regime that requires only notice of extrajudicial disposition of the encumbered assets is that it secures the right of the secured creditor to take possession of the encumbered assets without undue delay, while protecting the interests of the grantor and third parties with rights in the encumbered assets at the time prior to disposition. The disadvantage is that the grantor is given notice of extrajudicial enforcement after the secured creditor takes possession of the encumbered assets (this approach creates the problems mentioned in the preceding paragraph).

31. Regardless of which approach is taken, States must also decide what other notices may be required when a secured creditor seeks to enforce its security right extra judicially. Many States that require a prior notice of intended disposition of the encumbered assets do not also require a separate notice of default or a subsequent notice of extrajudicial enforcement. The assumption is that a single notice will be sufficient for all purposes. Other States that permit the notice of the specific extrajudicial enforcement method being pursued to be given after the creditor obtains possession of the encumbered assets, nonetheless require a pre-possession formal notice of default. Because the objective and contents of the pre-possession

notice of intention to enforce and the post-possession notice of extrajudicial enforcement largely overlap, no States that opt for the former also require the latter. To balance the interests of all parties, this Guide recommends that the secured creditor may take possession of the encumbered assets without applying to a court, provided that the grantor has consented to extrajudicial enforcement in the security agreement, does not object when the secured creditor seeks to obtain possession, and has given the grantor notice of default and of its intention to seek to obtain possession out of court (see A/CN.9/631, recommendation 143).

32. As with other situations where notice may be required, States usually specify with considerable care the minimum contents of a notice, the manner in which it is to be given and the persons to whom it must be given, in addition to its timing. Many States distinguish between notice to the debtor, notice to the grantor when the grantor is not the debtor, notice to other creditors and notice to public authorities or the public in general. It is a matter of a cost-benefit analysis whether the secured creditor should be required to give prior written notice to others beyond the debtor and grantor and other secured creditors known to exist (i.e. other secured creditors that have registered a notice of their rights or that have otherwise notified the secured creditor that proposes to dispose of the encumbered assets). Some States provide that the notice need be given only to the grantor and other secured creditors that have registered their rights, but that it then be registered and that thereafter the registrar be required to forward the notice to all those who have registered rights against the encumbered assets.

33. States also take different approaches to the minimum content of the notice. As with the decision about the timing of the notice and its recipients, decisions about the information to be included require States to undertake a cost-benefit analysis. For example, they might require the inclusion of the secured creditor's calculation of the amount owed as a consequence of default. They might further require advice to the debtor or grantor regarding what steps to take to pay the secured obligation in full or, if such a right exists, to cure the default. Moreover, some States provide that the notice to other interested parties need not be as extensive or specific as notice to the debtor and grantor. Again, where the notice is to be given prior to taking possession, States often place a higher information burden on secured creditors. Where the notice is given after possession, by contrast, the secured creditor is often obliged simply to provide basic information about the date, time, location and type of disposition being proposed and the delay within which the grantor or other interested party may contest the proposal or remedy the default.

34. There are different approaches to achieving the right balance between the need to ensure that the notice conveys to interested parties sufficient information to enable them to make an informed judgement about how best to protect their rights, and the need to achieve expeditious and low-cost enforcement. Some States place a heavy burden on secured creditors, both as to the timing and the content of the notice. Others impose only minimal requirements. This Guide recommends that the notice normally should be given prior to the secured creditor commencing enforcement (see A/CN.9/631, recommendation 145) and that rules should provide for it to be given in a timely, efficient and reliable way (see A/CN.9/631, recommendation 146), but that States have the flexibility to determine the specific manner for giving the notice and its specific contents (see A/CN.9/631, recommendation 147).

(c) Release of the encumbered assets and reinstatement of the secured obligation

35. Once a default has been signalled, the debtor, third-party grantor and interested third parties will often attempt to refinance the secured obligation or otherwise remedy the alleged default. In such cases, States must decide what rights these different parties may exercise and within what time frame they may be exercised. Typically grantors and third parties are given two types of right: release of the encumbered assets; and reinstatement of the secured obligation.

36. Release brings the secured transaction to an end because the grantor's obligation has been fully repaid. Since the objective of enforcement proceedings is to enable creditors to obtain repayment of the obligation, States are usually quite flexible about the parties entitled to pay the secured obligation. For example, most States permit a defaulting grantor to seek to obtain a release of the encumbered assets before their final disposition by the secured creditor upon paying the outstanding amount of the secured obligation, including interest and the costs of enforcement incurred up to the time of repayment. States usually also permit any interested third party (e.g. a creditor with a lower priority ranking than that of the enforcing creditor or a purchaser that takes the assets subject to the security right) to exercise the right of repayment if the grantor does not.

37. In addition, States usually take a flexible position in relation to the time within which repayment may be made. The secured creditor's interest is in being paid. As long as this payment of principal, interest and costs of enforcement incurred occurs before any third-party rights are affected, there is no reason for insisting on disposition of the encumbered asset. That is, whoever exercises the right may do so up until the time of (a) disposition of the encumbered asset or the completion of collection by the secured creditor after disposition of the encumbered asset; (b) the secured creditor entering into a commitment to dispose of the encumbered asset; or (c) acceptance by the secured creditor of the encumbered asset in total or partial satisfaction of the secured obligation, whichever occurs first. Until one of these events occurs, the secured obligation may be repaid in full and the encumbered assets released. For the same reasons (recognizing that the creditor's primary interest is in receiving payment and the grantor's primary interest is in not losing its property), this Guide recommends that repayment leading to release of the encumbered assets be permitted right up until third-party rights are acquired or the secured creditor has accepted the encumbered asset in satisfaction of the secured obligation (see A/CN.9/631, recommendation 140).

38. Reinstatement of the secured obligation is quite different from release of the encumbered assets and is usually more narrowly circumscribed. Reinstating the secured obligation means curing the specific default (e.g. paying any missed instalments, accrued interest and costs of enforcement already incurred), but otherwise it has no effect either on the grantor's continuing duty to perform or on the security right. The reinstated obligation remains enforceable according to the terms agreed by the parties and remains secured by the encumbered assets.

39. States take quite different approaches to the reinstatement right. Some do not legislatively provide for a reinstatement right, but allow parties to provide for such a right in the security agreement. By contrast, many States provide for such a right but limit its exercise to the grantor. Finally, some States permit any interested party to cure a default and reinstate the secured obligation. Whenever reinstatement is

permitted, parties authorized to do so may exercise the right up to the same time that parties authorized to release the encumbered assets may exercise their right of release. Because reinstatement maintains rather than extinguishes the secured obligation, the grantor may later again fall into default. To prevent a series of strategic defaults and reinstatements, States often limit the number of times that a secured obligation may be reinstated after default.

[Note to the Commission: The Commission may wish to consider adding a recommendation on the grantor's right to cure the default and reinstate the secured obligation.]

(d) Authorized disposition by the grantor

40. Following default, the secured creditor will be interested in obtaining the highest price possible for the encumbered assets. Frequently, the grantor will be more knowledgeable about the market for the assets than the secured creditor. For this reason, secured creditors will often permit the grantor to dispose of the encumbered assets even after enforcement has commenced. In most such cases, the parties agree that any amount received from the disposition will be paid to the secured creditor in the same manner as if payment resulted from enforcement proceedings. These arrangements have consequences for third parties that may also have rights in the encumbered assets, or a right to proceeds of their disposition. For this reason, some States explicitly provide that when a secured creditor that has commenced enforcement gives the grantor a limited time following default to dispose of the encumbered assets, the proceeds of the sale will, for all purposes, be treated as if they had arisen as a consequence of an enforcement disposition. Some States go further, and even prohibit the secured creditor from attempting to arrange for the disposition of the encumbered assets during a short period of time following default. Other States seek to achieve the objective of maximizing the amount received upon disposition by providing incentives for the grantor to bring potential buyers to the attention of the secured creditor. In any event, the point is to structure the enforcement regime so as to give the grantor the incentive to cooperate with the secured creditor in disposing of encumbered assets for the highest possible price.

4. Extrajudicial enforcement of the rights of the secured creditor

(a) General

41. In cases where a secured creditor elects to enforce the security agreement judicially, after judgement has been obtained, the normal rules of civil procedure relating to the post-judgement enforcement process will apply. Typically, this means that public officials or authorities (e.g. bailiffs, sheriffs, notaries or the police) will take possession of the encumbered assets and bring them to sale. Slightly different processes are required where a secured creditor has taken the steps that are necessary to commence enforcement proceedings and elects to exercise its rights out of court. As no public official is involved, the secured creditor will normally wish to, and typically will have to, obtain possession or control of the encumbered asset itself in order to proceed with enforcement. States have taken different policy approaches both to the right of the secured creditor to obtain possession and control of assets (as opposed to consigning encumbered assets to a bailiff) and, if direct creditor possession is permitted, to the procedural mechanisms that must be followed for doing so.

(b) Removing the encumbered assets from the grantor's control

42. Prior to default, the grantor will usually be in possession of the encumbered assets. Sometimes, however, the grantor will have already placed the secured creditor in possession, either at the time of making the security right effective between them (see A/CN.9/631, recommendation 14) or thereafter either as a means of achieving third-party effectiveness (see A/CN.9/631, recommendation 38) or in response to a later pre-default creditor request to control the assets. On other occasions, the encumbered assets may be in the possession or the control of a third party that is acting for, or under the direction of, the secured creditor. In both these situations, many States do not require the secured creditor to take any further steps in order to commence enforcement. That is, the creditor need not formally give the grantor notice of default, but need only send a notice of intended disposition once it has determined the recourse it intends to pursue. By contrast, some States require the creditor in possession to inform the grantor of the default and of the fact that it is now holding the encumbered assets in preparation for enforcement. These States usually also consider that, upon default, any agreement under which the creditor in possession may use the encumbered assets comes to an end.

43. Where the creditor is not in possession, it must take active steps to recover the encumbered assets from the grantor or to inform a third party holding on behalf of the grantor that the security right has become enforceable. States that provide for extrajudicial enforcement generally provide that, once a grantor is in default, the secured creditor has an automatic right to possession of the encumbered asset. That is, they do not require that, pending extrajudicial enforcement, the assets be placed under the control of a public official. The assumption is that flexibility in enforcement and lower-cost preservation of the assets pending disposition will result if the secured creditor can make decisions about where post-default possession and control should lie. This rationale also underlies the recommendation in this Guide that the secured creditor has upon default an automatic right to possession (see A/CN.9/631, recommendation 142).

44. A concomitant of the secured creditor's right to possession is its right to decide exactly how that possession should be exercised. In some cases, secured creditors will actually take personal possession of the encumbered assets against which they are proceeding. However, in many cases, they will not take possession of the assets. Secured creditors may, for example, have the assets placed in the hands of a court, or a State- or court-appointed official. More commonly, they will have the assets entrusted to a third-party depositary that they appoint, or (particularly in the case where a manufacturing operation is involved) will appoint a manager to enter into the premises of the grantor in order to take control of the encumbered assets. Where assets are already in the hands of a third party that is not acting for them, but that has previously been made aware of the security agreement, secured creditors may simply give notice that the agreement has become enforceable and that the grantor no longer has rights to retain possession, to control or to dispose of the encumbered assets.

45. States usually consider the taking of possession to be a significant step in the enforcement process and impose specific procedural requirements on creditors claiming possession. That is, even though the secured creditor may have an automatic right to possession, the manner for doing so is regulated. In general, States take one of three approaches in developing the procedural mechanisms by

which secured creditors not in possession may remove encumbered assets from the grantor's control. In some States, the secured creditor may only obtain possession by a court order, whether following an *ex parte* procedure, or more frequently, after a hearing. In other States, no judicial order is required, but the grantor must have authorized the creditor to obtain possession extrajudicially in the security agreement and the creditor must give the grantor a prior notice (typically 10 or 20 days) of its intention to claim possession and to enforce. Finally, in some States, the creditor is entitled to demand and to take possession without any recourse to a court and without the need to give the grantor a prior notice of its intention to do so, provided that the grantor authorized it to do so in the security agreement. Even in these States however, the creditor does not have an absolute right to obtain possession extrajudicially. There is always potential for the creditor abusing its rights by threatening the grantor, intimidation, breaching the peace or claiming the encumbered assets under false pretences. Most of these States, therefore, condition any acts of the creditor to obtain possession on the creditor avoiding a disturbance of the public order. Should the grantor resist, a judicial order for possession would be required. States that permit extrajudicial creditor possession upon the giving of a 10 or 20 day prior notice typically also adopt this approach to possession and require a judicial order if a breach of the peace is threatened when the creditor seeks possession after the delay has expired.

46. In States that impose a notice requirement on secured creditors as a precondition to obtaining possession, there is always a risk that a grantor in default may then seek to hide or transfer the encumbered asset before the secured creditor can take control of it. It may also be that the assets may be misused, may dissipate if not looked after or, depending on market conditions, may rapidly decline in value. To forestall these possibilities, most States provide that secured creditors may obtain expedited relief from a court or other relevant authority. Furthermore, in the special case where the encumbered assets threaten to decline rapidly in value, and whether or not secured creditors are required to give a prior notice of their intention to enforce, many States permit the court to order the immediate sale of these perishable assets.

47. The decision as to the formalities required in order for a secured creditor to obtain possession depends on the balance States strike between the protection of the rights of grantors and efficient enforcement to reduce costs. It also depends on a judgement as to the likelihood in practice of abuse by secured creditors or improper behaviour by grantors in possession. In order to reduce the cost of enforcement and minimize the chances that assets will be misused or dissipate in value, this Guide recommends that the secured creditor be authorized to obtain possession extrajudicially, but only if the grantor has so authorized in the security agreement, a notice of intention to take possession has been given to the grantor, and the grantor does not object at the time possession is being sought (see A/CN.9/631, recommendation 143). In addition, to maximize enforcement value where assets are perishable or are likely to decline rapidly in value during the period between the giving of notice and the time when the creditor may actually obtain possession of the assets, this Guide recommends that, as long as the grantor has authorized extrajudicial possession in the security agreement and the grantor does not object when possession is actually being sought, notice of the creditor's intention to take possession and to dispose of the assets need not be given (see A/CN.9/631, recommendation 145).

(c) Sale or other disposition of the encumbered assets

48. Because a security right entitles the secured creditor to obtain the value from the sale of the encumbered assets and to apply it to the secured obligation, States usually regulate in some detail the procedures by which the secured creditor may seize and dispose of these assets. Requirements range from the less to the more formal. For example, even when extrajudicial enforcement is permitted, some States require disposition to be subject to the same public procedures used to enforce court judgements. Other States require secured creditors to obtain judicial approval of the proposed mode of disposition before proceeding. Still other States permit the secured creditor to control the disposition but prescribe uniform procedures for doing so (e.g. rules relating to public auctions or a call for tenders). On occasion, States actually oblige the secured creditor to obtain the consent of the grantor as to the mode of disposition. Finally, some States give the secured creditor a wide, unilateral discretion as to the mode of disposition, but subject this conduct to general standards of conduct (e.g. good faith and commercial reasonableness), the breach of which leads to the creditor's liability in damages.

49. Most commonly, the procedural safeguards by which States control the actions of secured creditors relate to the details of the notice that must be given to the grantor and third parties with a right in the encumbered assets. In principle, the types of detail required should be identical whether States opt for a pre-possession notice approach or a post-possession notice approach. So, for example, States often require creditors to indicate the method of advertising a proposed disposition, the date, time and location of the sale, whether the sale will be by public auction or by tender, whether the assets will be sold individually, by lot or as a whole, and whether the disposition includes leases, licences or associated permits where required. The objective should be to maximize the amount realized for the encumbered assets, while not jeopardizing the legitimate claims and defences of the grantor and other persons. This explains why even States that generally require detailed notices do not do so when the encumbered assets are to be sold on a recognized public market. In such cases, the market sets the value of the assets and there is no higher price to be obtained by adopting and giving notice of some other mode of sale (see A/CN.9/631, recommendation 145).

50. Because an extrajudicial disposition of encumbered assets has the same finality as a court-supervised sale, most States not only impose relatively detailed rules as to the contents of the notice and the time that must elapse before the sale can take place, but also permit interested parties to object to the timing and manner of the proposed disposition. Typically, special expedited procedures are available so that objections may be quickly heard and dealt with (see A/CN.9/631, recommendations 137 and 141). As a general rule, where the enforcing creditor has the greatest flexibility as to timing and method of disposition, the cost of enforcement is lowest, the enforcement is most expeditious and the proceeds received are highest. For these reasons, this Guide recommends flexibility for secured creditors and only the basic minimum of detail in the notice necessary to alert interested parties to the enforcement and the need to protect their interests should they wish (see A/CN.9/631, recommendations 146 and 147).

(d) Acceptance of the encumbered assets in satisfaction of the secured obligation

51. The underlying rationale for creating a security right is to enable the secured creditor to realize the value of the encumbered asset and to apply the money received to payment of the grantor's obligation. For this reason, in many States, a creditor's only recourse upon default is to seize the encumbered assets and sell them. In most States that so limit the secured creditor's extrajudicial recourses, the limitation applies even when the creditor is already in possession of the encumbered assets under a pledge agreement. That is, in these States it is not possible for the parties to agree in advance that, should the grantor default, the secured creditor may keep the encumbered assets in satisfaction of the secured obligation. Similarly, in many of these States, the secured creditor may not take the encumbered assets as a remedy after default has occurred. Moreover, even if, after default, the grantor and the secured creditor agree that the secured creditor may keep the encumbered assets, in these same States such arrangements are considered as a contractual payment and have no effect on the rights of any other party with a right in the encumbered assets.

52. By contrast, in many States, the secured creditor is entitled to propose to the grantor that it accept the encumbered assets in full or partial satisfaction of the secured obligation. Where such an enforcement remedy is made available to secured creditors, States usually provide that any agreement that automatically vests ownership of the encumbered assets in the secured creditor upon default is unenforceable if entered into prior to default. However, the agreement is enforceable if made after default and according to the specific enforcement procedures meant to prevent creditor abuse. These States usually also provide that any informal private agreements entered into by grantors and secured creditors after default are enforceable, but only as contractual payment remedies that have no effect on third parties with rights in the encumbered assets.

53. Where States expressly permit the creditor to take the encumbered assets in satisfaction of the secured obligation after default, provided that it has followed the required procedural steps, this does not mean that the grantor must accept the secured creditor's offer. The grantor may refuse to do so, with the consequence that the secured creditor will have to pursue one of its other remedies. The advantage of permitting these types of post-default agreement is that they can often lead to less expensive and more expeditious enforcement. The disadvantage is that there may be a risk of abuse by the secured creditor in cases where (a) the encumbered assets are more valuable than the secured obligation; (b) the secured creditor has, even in the post-default situation, unusual power over the grantor; or (c) the secured creditor and the grantor come to an arrangement that unreasonably prejudices the rights of third persons with a right in the encumbered assets.

54. To guard against the potential for abusive or collusive behaviour by the secured creditor and the grantor, some States require not only the consent of the grantor to the acceptance by the secured creditor, but also that notice be given to third parties with rights in the encumbered assets. These third parties then have a right to object to the proposed agreement and may require the secured creditor to enforce the security by means of a sale. In addition, some States require the consent of a court under certain circumstances, such as where the grantor has paid a substantial portion of the secured obligation and the value of the encumbered assets greatly exceeds the outstanding obligation. Finally, some States require that a secured creditor that proposes to accept encumbered assets in satisfaction of the

secured obligation be required to provide an official and independent appraisal of the value of the encumbered assets before proceeding.

55. Whether States should impose any or all of these requirements, and especially the requirement of prior judicial involvement, will depend on their assessment of the costs and benefits of each requirement. In line with the general objective of maximizing flexibility so as to obtain the highest possible value for encumbered assets at the point of enforcement, this Guide recommends that either the secured creditor or the grantor may propose to the other that the assets be taken in satisfaction of the secured obligation (see A/CN.9/631, recommendations 148 and 151). Likewise, to ensure that all parties understand the full implications of the proposal, this Guide recommends that adequate notice of the secured creditor's intention to accept the assets in payment is given to the grantor and third parties, and that the notice indicates not only the assets to be taken in satisfaction, but also the amount owed at the time the notice is sent, the amount of that obligation that is proposed to be satisfied by the acceptance, and a relatively short period of time at the expiration of which the proposal will be deemed to be accepted (see A/CN.9/631, recommendation 149). The assumption is that requiring the secured creditor to indicate its own valuation of the encumbered assets is a more efficient and less costly mechanism for providing relevant information to interested parties than providing for an independent appraisal. It is also assumed that, once informed of the secured creditor's proposal, the grantor or third parties will be in a position to assess its reasonableness. This is why this Guide further recommends that the grantor or third parties that object to the proposal have a right to require the secured creditor to abandon this recourse and proceed rather to a sale in disposition (see A/CN.9/631, recommendation 150).

(e) Management and sale of a business

56. In many circumstances a secured creditor has security not just on specific assets of a grantor, but on most or all of the assets of a business. In these situations, the highest enforcement value can often be obtained if the business is sold as a going concern. In order to be able to do so efficiently, secured creditors must usually be able to dispose of all these assets, including immovable property. Moreover, in such cases, States often prescribe special notice procedures for the sale and more strictly regulate the conditions under which the sale of a business as a going concern may take place.

57. Alternatively, in many cases where enforcement becomes necessary, it is not in the interest of the grantor or the secured creditor to immediately dispose of all the assets of a business, whether these are sold by category (e.g. inventory, equipment and licences) or whether the business is sold as a whole. For this reason, many States permit secured creditors to take possession of business operations and manage the business for a certain period of time after default. Frequently, these States require that the notice of enforcement specifically indicate that when the creditor takes possession of the encumbered assets it intends to gradually wind down the business. This is especially important for other creditors that otherwise may not know that liquidation is taking place. Some States also prescribe special procedures for naming a manager, for operating the business, for alerting suppliers of the secured creditor's rights and for informing customers that what looks like an ordinary-course-of-business sale is in fact part of an enforcement process.

58. When inventory has been effectively liquidated, the secured creditor will typically proceed to exercise another of its remedies. In such cases, most States require the secured creditor to give a further notice to the grantor and other parties with a right in the remaining assets (most often equipment, leases, licences and a remnant of inventory) that it proposes to exercise another of its remedies (e.g. accepting the assets in satisfaction, or more commonly, selling them). Once such a notice is given, then the regular enforcement procedures applicable to that recourse will apply.

[Note to the Commission: The Commission may wish to consider adding a recommendation on the secured creditor's right to take over the management of a business and to sell the assets as it winds down that business.]

(f) Remedies cumulative

59. It will sometimes happen that, in order to completely dispose of all the encumbered assets, a creditor will be obliged to exercise more than one remedy. As noted, this typically occurs when a secured creditor liquidates a business. However, it may occur because, for example, security in inventory may be most effectively enforced through a sale, or security in equipment may be most efficiently enforced through the acceptance of the assets by the secured creditor in satisfaction of the secured obligation. In addition, there will occasionally be situations where a secured creditor believes that one remedy will be optimal, only to discover that another will generate a higher value upon disposition. This is why most States provide that a secured creditor's remedies are cumulative. That is, the enforcing creditor may not only have the option of selecting which recourse to pursue, it may exercise different remedies either at the same time or one after the other. It may even concurrently pursue both judicial and extrajudicial remedies. Only where the exercise of one remedy (e.g. repossession and disposition of an encumbered asset) makes it impossible to exercise another remedy (e.g. acceptance of an encumbered asset in satisfaction of the secured obligation) will the creditor not be able to cumulate remedies. Here also, the Guide adopts the policy that maximizing flexibility in enforcement is likely to ensure that the highest value is received for the encumbered assets and recommends that secured creditors be permitted to cumulate their judicial and extrajudicial remedies (see A/CN.9/631, recommendation 138).

60. A security right is granted in order to enhance the likelihood of a creditor receiving payment of the secured obligation. The various post-default enforcement remedies, and especially extrajudicial remedies of the secured creditor, are meant to achieve this objective. Some States do not permit secured creditors to cumulate both their remedies with respect to the encumbered assets and their remedies with respect to the secured obligations. The assumption is that these extrajudicial remedies are a favour given to the secured creditor and that the creditor ought, therefore, to be required to opt either to enforce the security right or to bring a judicial action to enforce the secured obligation. Other States permit the secured creditor to cumulate both its extrajudicial remedies and its right to enforce the obligation as a matter of contract law. Moreover, they permit the two proceedings to be brought concurrently or serially in either order. To require a secured creditor to opt, at the outset of enforcement, for one or the other mode of proceeding will complicate and increase the cost of enforcement because it will require a creditor to determine if a deficiency is likely to result. If it comes to that conclusion it will be obliged to bring an action

to enforce the obligation and assert its priority only at the moment of a judicial sale in enforcement. This is a less expeditious process, is more costly, and will normally produce less value at the time of sale. To maximize enforcement value, this Guide recommends that secured creditors be permitted to cumulate proceedings to enforce the security extrajudicially and to enforce the secured obligation through a judicial process, subject always to the limitation that the secured creditor cannot claim more than it is owed (see A/CN.9/631, recommendation 139).

5. Effects of enforcement

(a) The grantor, the secured creditor and third parties

61. In order to make the enforcement regime as expeditious as possible, States typically enact detailed rules that determine the effect of enforcement on the relationship between the grantor and the secured creditor, the rights of parties that may purchase the encumbered assets at an enforcement sale, and the rights of other secured creditors to receive the proceeds generated by the sale of the encumbered assets. The primary object of an enforcement procedure is, of course, to generate value for the secured creditor that can be deployed to satisfy the unpaid secured obligation. In the most common situation, the secured creditor will acquire this value by selling the encumbered assets and appropriating the proceeds. Should there be a surplus, the secured creditor must return this to the grantor or to any other person entitled to it. Moreover, as just noted, should there be a deficiency, most States provide that the secured creditor retains an ordinary contractual right to sue the grantor for the deficiency as an unsecured creditor. The details of how proceeds of distribution are normally allocated in these cases are discussed below (paras. 67 and 68).

62. As noted, however, sometimes the secured creditor will take the encumbered asset in satisfaction of the secured obligation. Not all States adopt identical rules to govern the effects of this particular recourse. Usually, States provide that the creditor that takes the asset in satisfaction may keep it, even where the value of the asset exceeds the amount of the secured obligation still owed. That is, unlike the case of a sale, the secured creditor may keep a surplus. Concomitantly, many of these States provide that the secured creditor that accepts the asset in satisfaction of the obligation has no recourse for a deficiency against the grantor. The acceptance is deemed to be complete payment and therefore extinguishes the secured obligation. By contrast, however, other States permit creditors that have taken encumbered assets in satisfaction of the secured obligation to pursue their grantor for a deficiency. In these cases, of course, it becomes necessary to establish the value of the assets being taken in satisfaction so that the amount of the deficiency may be calculated. Some States require the secured creditor to provide an independent accounting of the value of these assets taken, while other States merely require the secured creditor to indicate the value that it ascribes to these assets. In either case, as noted, the grantor or other creditor may require the secured creditor to sell the asset instead. For reasons already given (see para. 55 above), this Guide recommends that secured creditors may take the asset in total or partial satisfaction of the secured obligation, provided that they indicate the value they ascribe to it in the notice sent to the grantor and third parties (see A/CN.9/631, recommendation 149).

(b) Other parties

63. When a secured creditor enforces its security right by means of a sale of the encumbered assets, there are different approaches to determining the effects of the sale on other parties. In some States, the sale (even when it is an extrajudicial sale) will purge all security rights in the encumbered assets. In such cases, even secured creditors with a priority ranking higher than that of the enforcing secured creditor will lose their security and will only have a claim in the proceeds with an equivalent priority ranking. Parties that purchase the assets will obtain a clear title and, it is presumed, will be willing to pay a premium to do so. In other States, the sale by a creditor (whether it is managed by a judicial officer or it is a private sale by the creditor) will only extinguish rights with a lower priority ranking than that of the enforcing secured creditor and the secured creditor with a higher priority ranking will retain its security right in the encumbered assets. Purchasers at the sale will not obtain a clear title and will, consequently, discount the amount they offer for the assets being sold. The assumption is that the highest ranking secured creditor normally will either take over the enforcement (so that all security rights will be extinguished) or that a lower ranking secured creditor will arrange to pay off the higher ranking creditor so as to produce a clear title. While either approach usually will produce a clear title, the second approach maximizes the flexibility of the enforcing creditor and the purchaser to reach an alternative arrangement in the event that the purchaser cannot finance the entire cost of the secured asset and is willing to purchase it for a discounted price because it is subject to a higher ranking security right. To maximize flexibility and efficiency in enforcement, this Guide recommends adoption of the second approach (see A/CN.9/631, recommendation 158).

64. When a secured creditor takes the encumbered assets in satisfaction of the secured obligation, States usually provide that the secured creditor takes the assets as if they were transferred through an enforcement sale. While it is possible that States could provide that an acceptance in satisfaction of the secured obligation operates a purge of all rights, this would invariably lead secured creditors with a higher priority ranking than that of the enforcing secured creditor to take over the enforcement process. Therefore, most States provide that the rights of other secured creditors are determined by their priority relative to the enforcing creditor. So, for example, where a State permits a secured creditor to take an encumbered asset in satisfaction of the secured obligation, that creditor will acquire the asset subject to the rights of secured creditors with a higher priority ranking. Conversely, if there are secured creditors with even lower priority, their rights will normally be extinguished upon acceptance of the encumbered assets by a secured creditor with higher priority. For the same reasons that apply to the remedy of extrajudicial sale, this Guide recommends that the secured creditor that accepts the asset in satisfaction takes it free of lower priority security rights, but subject to the rights of secured creditors with a higher priority (see A/CN.9/631, recommendation 158).

65. The secured creditor that has a higher priority will often wish to take over an enforcement process commenced by another creditor (whether this is under judgement enforcement proceedings or enforcement being pursued by another creditor exercising a security right). States usually provide for a takeover right from secured creditors enforcing under secured transactions law, but some do not permit secured creditors to pursue extrajudicial enforcement once a judgement creditor

(whether an unsecured judgement creditor, or a secured creditor that may have also taken judicial enforcement proceedings) has seized the encumbered assets. Where a takeover right is given to a secured creditor against enforcement by a judgement creditor, States often require the secured creditor to exercise the right in a timely manner (i.e. before the auction begins) and to reimburse the judgement creditor for enforcement expenses incurred up to that moment. In order to maximize the efficiency of the enforcement of security rights, this Guide recommends that a secured creditor with a priority ranking higher than that of the enforcing secured creditor is entitled to take control of enforcement both against other secured creditors pursuing extrajudicial enforcement and as against judgement creditors (see A/CN.9/631, recommendation 156).

(c) Allocation of proceeds of disposition

66. One of the important features of secured transactions law is that it disrupts the normal rules for distributing the proceeds of disposition that apply as between unsecured judgement creditors. After all, the object of the security is to obtain a priority in the distribution of these proceeds. Should the enforcement of the security right have taken place judicially or should the secured creditor not have taken over an enforcement process brought by a judgement creditor, the proceeds will be held by a public authority pending their distribution to parties entitled to them. When the regime provides for a purge of rights, the most common allocation is to pay reasonable enforcement costs first and then the secured obligations in the order of their priority. Many States also provide for the payment of certain statutory claims, after costs of enforcement but in priority to secured creditors. If the ordinary enforcement process does not provide for a purge of rights, secured creditors will not receive payment, but will be able to assert their security rights against the purchaser.

67. Where a secured creditor enforces through an extrajudicial sale, States typically provide in their secured transactions law a series of rules relating to the proceeds of the sale. Often there are special rules dealing with the manner by which proceeds are to be held by the secured creditor pending distribution. These rules usually also prescribe if and when a secured creditor is responsible for distributing proceeds to some or all other creditors (such as secured creditors with security rights in the encumbered assets with a lower priority ranking than that of the enforcing secured creditor or, if the enforcement regime provides for a purge of rights, to secured creditors with a higher priority ranking and statutory priority claimants). Often, the secured creditor need only take account of these other rights if they are registered or have otherwise been made effective against third parties, or if it has been expressly notified of them (e.g. the case of statutory priority claims that need not be registered). Invariably States also provide that any surplus proceeds after all creditors entitled to payment have been satisfied are to be remitted to the grantor (see A/CN.9/631, recommendation 152).

68. The secured obligation is discharged only to the extent of the proceeds received from the sale of the encumbered assets. Normally, the secured creditor is then entitled to recover the amount of the deficiency from the grantor. Unless the grantor has created a security right in other assets for the benefit of the creditor, the creditor's claim for the deficiency is an unsecured claim. Regardless of whether there is a deficiency or a surplus, some States provide that, when a secured creditor

purchases the encumbered assets at an enforcement sale and later sells them at a profit, the amount received for the sale that exceeds the amount paid by the creditor and the costs of the further sale, is deemed to be received in satisfaction of the secured obligation. Generally, however, unless the initial sale can be shown to have been commercially unreasonable, States consider the amount generated to be the final value received upon disposition of the encumbered assets.

(d) Finality

69. Secured transactions laws normally provide finality following enforcement. This means that, once the sale or acceptance in satisfaction has taken place according to the required enforcement procedures, it normally cannot be reopened. Unless fraud, bad faith or collusion between seller and buyer can be proved, the sale is final. Whether the secured creditor accepts the encumbered asset in satisfaction of the secured obligation or whether the assets are sold to a third party that acquires them at an enforcement sale, the effects of the enforcement on other parties are usually the same. The security right in the encumbered assets terminates, as do the grantor's rights and the rights of any secured creditor or other person with a lower priority ranking in the assets. In States where the sale produces a total purge of rights in the encumbered assets, the purchaser or the creditor that takes the encumbered assets in satisfaction of the secured obligation obtains a clear title. Most often, however, the law provides that the rights of certain other persons in the encumbered assets (most notably secured creditors with a higher priority ranking than that of the enforcing secured creditor) continue notwithstanding disposition of the assets in the enforcement procedure.

B. Asset-specific remarks

1. General

70. The basic principles governing enforcement of security rights just reviewed ought generally to apply whatever the type of encumbered asset. Nonetheless, they primarily envision certain types of tangible property, such as inventory, equipment and consumer goods. For this reason, these rules do not easily apply either to the enforcement of security rights in intangible property, such as receivables and various payment rights (such as rights to payment of funds credited to a bank account) and proceeds under an independent undertaking, or to payment rights arising from negotiable instruments and rights to possession arising from a negotiable document (for the definitions of these terms, see A/CN.9/631/Add.1, Introduction, sect. B. Terminology and rules of interpretation). Consequently, many States have enacted special rules governing enforcement against these types of encumbered asset and in particular in respect of payment rights. These include, among others, provisions giving the secured creditor the right to collect from the person obligated on the receivable or negotiable instrument and requiring that person to make payments directly to the secured creditor. Moreover, in many of these cases, secured transactions law must accommodate, and in part defer to, the specialized law and commercial practices governing bank accounts, negotiable instruments, negotiable documents and independent undertakings.

71. As previously mentioned, the basic principles in section A of this chapter generally envision encumbered assets as tangible property acquired, used and sold as separate objects. Yet tangible property is often attached to other movable or immovable property, or commingled in a mass, or manufactured into a product. These dealings require States to adjust the general regime to govern enforcement of competing security rights in attachments and manufactured products. This is most notably the case when tangible property is attached to, or detached from, immovable property. For example, there may be priority conflicts between creditors enforcing a mortgage on land and creditors with a security right in an attachment to that land. The most common of these different situations and the different approaches that States can take to ensure efficient enforcement of competing security rights are considered in turn.

2. Enforcement of a security right in a receivable

72. When a security right is taken in a receivable, the encumbered asset is the grantor's right to receive payment from the debtor of the receivable (for the definitions of the terms "receivable", "assignment", "assignor", "assignee" and "debtor of the receivable", see A/CN.9/631/Add.1, Introduction, sect. B. Terminology and rules of interpretation). While it would be theoretically possible to require the assignee to enforce the assignment by seizing the receivable and either selling it or keeping it in satisfaction of the secured obligation, this would be a cumbersome and inefficient way of realizing the economic value of the asset. This is the reason why most States that permit creditors to take security in receivables and other claims, enable the assignee to collect payment directly from the debtor of the receivable once the assignor is in default. The primary concerns are two: first, that the assignor knows that the assignee is enforcing (either after default, or with the agreement of the grantor before default); and second, that the debtor of the receivable knows that it must thereafter make payments to the assignee.

73. In chapter VIII, Rights and obligations of the parties, this Guide discusses the relationship between the assignor, the assignee and the debtor of the receivable. Issues discussed include, for example, the right of the assignee to inform the debtor of the receivable to make payments directly to the assignee following the assignor's default (see A/CN.9/631, recommendations 110-113). The Guide also provides, in chapter IX, Rights and obligations of third-party obligors, that the debtor of the receivable is protected against having to pay twice by the notification and payment instruction given by the assignee or the assignor (see A/CN.9/631, recommendations 114-120).

74. Many States take the position that the assignee's primary enforcement right is simply to collect the receivable. Assuming that it has followed the steps required to make its rights effective against the debtor of the receivable, the assignee will simply collect payment, applying the proceeds to reduction of the assignor's obligation. The rationale is that the rights of the assignor and third parties will be protected simply by the normal application of the money received to a reduction of the secured obligation. Consistent with the approach taken by these States, this Guide recommends that no further steps to achieve enforcement need be taken (see A/CN.9/631, recommendation 163).

75. Nonetheless, there may be cases where the assignee may wish to appropriate the entire present value of a receivable that may be spread out in instalments due

over several months. It may, therefore, after notifying the debtor of the receivable that it will be collecting the account, sell or transfer the receivable to a third person. To protect the assignor's rights in such cases, many States provide that the assignee may not keep any excess, a position this Guide adopts not only in relation to such dispositions of receivables, but also in relation to the ordinary collection of receivables (see A/CN.9/631, recommendation 113, subpara. (b)). Moreover, the assignee must act in a commercially reasonable manner in disposing of the receivable (see A/CN.9/631, recommendation 128).

76. In some cases, the receivable itself will be secured by some other personal or property right (e.g. a personal guarantee by a third party or a security right on movable property of the debtor of the receivable). Many States provide for an automatic right of the assignee to enforce these other rights should the debtor of the receivable be in default to pay the receivable as it falls due. This is a normal consequence of a security right (the accessory follows the principal) and this Guide adopts a like recommendation concerning guarantees of the third-party obligor's obligation to pay (see A/CN.9/631, recommendation 164). This rule applies to proceeds under an independent undertaking as well (see A/CN.9/631, recommendations 26, subpara. (b), 49, 105, 124 and 164).

3. Enforcement in the case of an outright transfer of a receivable

77. This Guide applies to outright transfers of receivables as well as security rights in receivables (see A/CN.9/631, recommendation 3). However, in an outright transfer, the assignor has generally transferred all of its rights in the receivable. Thus, the assignor has no continuing right in the receivable and no interest in the realization (usually collection) of the receivable. Accordingly, this chapter on enforcement applies to the outright transfer of a receivable only when the assignee has some recourse to the assignor for the non-collection of the receivables. That is, it is only where the assignor may ultimately be liable to the assignee that it has an interest in the method of the collection or other disposition of the receivables (see A/CN.9/631, recommendation 162).

78. Recourse to the assignor for the non-collection of receivables that have been the subject of an outright transfer usually arises when the assignor has guaranteed some or all of the payment of the receivables by the debtor of the receivables. Recourse may also arise from other functionally equivalent arrangements, such as when (a) the assignor agrees to repurchase a receivable sold to the assignee if the debtor on the receivable fails to pay; or (b) the assignor merely agrees to pay any deficiency between the purchase price for the bulk sale of receivables and the actual collections on those receivables.

79. Recourse to the assignor for non-collection as used here refers only to non-collection because of the failure of the debtor of the receivable to pay for credit reasons (e.g. its financial inability to pay). Consequently, the failure of the debtor of the receivable to pay for tangible property or services because of their poor quality or the failure of the assignor to comply with its specifications for the property or services would not be considered as non-collection. Where non-payment arises for credit reasons, however, the normal rules for collection of receivables and enforcement of the security would apply (see A/CN.9/631, recommendations 163 and 164).

4. Enforcement of a security right in a negotiable instrument

80. In many States, it is possible to acquire a security right in a negotiable instrument (for the definition of “negotiable instrument”, see A/CN.9/631/Add.1, Introduction, sect. B. Terminology and rules of interpretation), whether by taking possession or following other steps to achieve third-party effectiveness (see A/CN.9/631, recommendations 33 and 38). As a rule, even where there is a security right in the instrument, States defer to law governing negotiable instruments in determining the rights of persons obligated on the negotiable instrument and other persons claiming rights in the negotiable instrument (see A/CN.9/631, recommendation 121). These rights might include, for example, (a) the right of the person obligated on the negotiable instrument to refuse to pay anyone other than a holder or other person entitled to enforce the instrument under law governing negotiable instruments; and (b) the right of the person obligated on the instrument to raise certain defences to that obligation.

81. Where security is taken in a negotiable instrument, secured creditors will normally have possession or control of the instrument. Upon default of the grantor, many States permit the secured creditor to collect or otherwise enforce its security right in the instrument. This would include, for example, presenting it for payment, or, if default occurs before maturity, even selling it to a third party and using the proceeds to pay the grantor’s obligation. The rationale is that it would compromise the negotiability of the instrument if the secured creditor were obliged to go through the formalities required to exercise either the recourse of sale or taking the instrument in satisfaction of the secured obligation. Consistent with such practices, this Guide does not recommend that any further post-default formalities be imposed on enforcing secured creditors (see A/CN.9/631, recommendation 165).

82. As with receivables, it may be that the negotiable instrument is itself secured by some other personal or property right (e.g. a personal guarantee by a third party or a security right in movable property of the debtor of the receivable). Many States provide for an automatic right of the secured creditor to enforce these other rights should the person obligated under the negotiable instrument fail to pay upon presentment. This Guide recommends such an approach to enforcement of guarantees relating to the payment of a negotiable instrument (see A/CN.9/631, recommendation 166).

5. Enforcement of a security right in a right to payment of funds credited to a bank account

83. Many States envision the possibility of creating a security right in a right to payment of funds credited to a bank account (for the definition of this term and other relevant terms, see A/CN.9/631/Add.1, Introduction, sect. B. Terminology and rules of interpretation). In a bank account agreement, the bank is usually considered to be the debtor of the depositor and is obliged to pay the depositor a portion of or the whole amount on deposit when requested. Because banking law is closely tied to significant commercial practices within States, this Guide recommends deference to banking law and also provides additional safeguards for banks whose depositors may have granted security rights in their rights to payment of funds credited to a bank account (see A/CN.9/631, recommendations 33, 50, 101, 102, 122 and 123). For example, even if a depositor has concluded a security agreement with a creditor, the depositary bank has (a) the same rights and obligations in relation to its

depositor; (b) the same rights of set-off; (c) no obligation to pay any person other than the person that has control of the account; and (d) no obligation to respond to any requests for information (see A/CN.9/631, recommendations 122 and 123).

84. Many States provide that, if the encumbered asset is a right to payment of funds credited to a bank account, the secured creditor may collect or otherwise enforce its right to payment of the funds after default or even before default if so agreed with the grantor. Enforcement would normally occur by the secured creditor asking the bank to transfer the funds to its own account, or otherwise to collect the sums credited to the account. The rationale for this rule is that the encumbered asset is the right to receive payment of the funds credited to the account and that it would be inefficient if the secured creditor were required to enforce by taking possession and following the steps applicable to the sale of encumbered assets or by taking them in satisfaction of the secured obligation. Consistent with the objective of enhancing flexibility and efficiency in enforcement, this Guide recommends that creditors enforcing security in a right to payment of funds credited to a bank account may do so by collecting the money in the account (see A/CN.9/631, recommendation 167).

85. Sometimes, States require the secured creditor to obtain a court order prior to enforcement of a security right in a right to payment of funds credited to a bank account. Such a requirement is understandable in situations where the secured creditor may have obtained third-party effectiveness through registration in the general security rights registry. However, where the bank is aware of the security right because it has entered into a control agreement with the secured creditor, requiring a court order would be an unnecessary formality. For this reason, this Guide recommends that, where a control agreement has been entered into, it is not necessary to obtain a court order for the secured creditor to commence enforcement (see A/CN.9/631, recommendation 168). Conversely, where no such agreement has been entered into, this Guide recommends that a court order be required, unless the bank specifically consents to collection by the secured creditor (see A/CN.9/631, recommendation 169).

86. In many cases, the secured creditor will, in fact, be the depositary bank itself. Here, a formal enforcement process involving a specific act of collection and appropriation of the funds to repayment of the secured obligation would be superfluous. Upon default, a depositary bank acting as a secured creditor normally will deploy its right of set-off to apply the funds in the account directly to payment of the secured obligation in default. In keeping with this practice, this Guide recommends that enforcement of the depositary bank's rights of set-off not be affected by any security rights that the bank may have in the right to payment of funds in that account (see A/CN.9/631, recommendations 27 and 122, subpara. (b)).

6. Enforcement of a security right in proceeds under an independent undertaking

87. Today, some States permit persons that have the right to demand payment ("to draw") under an independent undertaking to grant security in the proceeds of that right (for the definition of this term and other relevant terms, see A/CN.9/631/Add.1, Introduction, sect. B. Terminology and rules of interpretation). This Guide recommends that security rights may be created in such proceeds, subject to a series of rules governing the obligations between the guarantor/issuer, confirmer or nominated person and the secured creditor (see A/CN.9/631,

recommendations 26, 28, 49 and 51). Because the law and commercial practices governing independent undertakings are quite specialized, this Guide recommends adoption of a number of rules meant to reflect existing law and practice (see A/CN.9/631, recommendations 124-126). So, for example, where the security right is automatically created, no separate act of transfer by the grantor should be necessary for the secured creditor to enforce a security right in a right to proceeds under an independent undertaking.

88. The general practice of States is to permit a secured creditor whose security right is in the proceeds under an independent undertaking to collect or otherwise enforce its right to payment of the proceeds after default or even before default if so agreed with the grantor. However, enforcement does not permit the secured creditor to demand payment from the guarantor/issuer, confirmer or nominated person (see A/CN.9/631, recommendation 28). Rather, enforcement would normally occur when the secured creditor indicates to the guarantor/issuer, confirmer or other nominated person that it is entitled to be paid whatever proceeds are otherwise due to the grantor. The rationale for this approach is that the guarantor/issuer, confirmer or other nominated person cannot be obliged towards anyone other than the beneficiary and only the beneficiary may request payment of the independent undertaking. This Guide follows the practice relating to independent undertakings and recommends that the enforcement of the security right be limited to collecting the proceeds once they have been paid (see A/CN.9/631, recommendation 170).

7. Enforcement of a security right in a negotiable document

89. Many States permit grantors to create security over a negotiable document (for the definition of this term and other relevant terms, see A/CN.9/631/Add.1, Introduction, sect. B. Terminology and rules of interpretation). This Guide recommends a similar practice (see A/CN.9/631, recommendations 2, subpara. (a), and 29). The negotiable document itself represents the tangible property that is described in it and permits the holder of the document to claim that property from the issuer of the document. Normally, secured creditors will enforce their security right by presenting the document to the issuer and claiming the property. Special rules may, however, apply to preserve the rights of certain persons under the law governing negotiable documents and this Guide defers to these special rules (see A/CN.9/631, recommendation 127).

90. Nonetheless, as between the grantor and the secured creditor, enforcement will occur when the secured creditor presents the document to the issuer. At this point, the secured creditor will be in possession of tangible property and enforcement of the security right will then be subject to the normal principles recommended for the enforcement of security rights in negotiable documents or goods covered by them (see A/CN.9/631, recommendation 171). Depending on the agreement between the parties, either upon default or prior to default with the grantor's permission, the secured creditor may dispose of the document. This must be done in a commercially reasonable manner and the price obtained for the sale of the document will be applied to satisfaction of the secured obligation.

8. Enforcement of a security right in proceeds

91. In the normal course of a business operation, tangible property like inventory is meant to be sold. In any case, if the grantor sells the encumbered assets

(in particular with the authorization of the secured creditor, in which case the security right does not continue in the encumbered assets; see A/CN.9/631, recommendation 86, subpara. (a)), the proceeds of the sale take the place of the encumbered assets (for the definition of “proceeds”, see A/CN.9/631/Add.1, Introduction, sect. B. Terminology and rules of interpretation). Hence, many States provide that a security right in tangible property will automatically pass into the proceeds of its disposition. Other States either do not so provide, or require that the security agreement expressly indicate which proceeds will be covered by the security. This Guide recommends that secured creditors have a right to claim their security in proceeds of encumbered assets and proceeds of proceeds (see A/CN.9/631, recommendations 40 and 41). Moreover, unlike many States that limit the concept of proceeds to replacement property, this Guide considers proceeds to include anything that is received on account of the encumbered asset, any fruits and revenues it generates and the natural increase of animals or plants.

92. Generally, States do not enact separate rules governing the enforcement of security rights in proceeds. That is, enforcement against proceeds will follow whatever type of process is required in order to enforce security against that type of asset (e.g. a tangible property, a receivable, a negotiable instrument, rights to payment of funds credited to a bank account, and so on). It would create considerable confusion if secured creditors were able to enforce security rights in proceeds according to the rules governing enforcement against the initially encumbered assets when other creditors seeking to enforce security rights against those proceeds as initially encumbered assets would have to follow rules specifically applicable to that type of asset. This Guide implicitly recommends that the general enforcement rules apply also to the enforcement of security rights in proceeds, except if the proceeds are receivables or other specific assets like those mentioned in the preceding paragraphs. In such a case, the asset-specific enforcement recommendations just described would apply.

[Note to the Commission: The Commission may wish to consider adding a recommendation that specifically addresses enforcement against proceeds and that explicitly notes that where proceeds are of a special category of assets (like receivables) enforcement should follow the rules applicable to that category of asset.]

9. Enforcement of a security right in an attachment to movable property, a mass or a product

93. Many types of tangible property in which a security right has been created are destined either to be attached to other tangible property, to be manufactured into a product or to be commingled with other tangible property. Many States deal with security rights in such cases by rules that determine whether ownership in the attachment, manufactured product or commingled property has passed to a third party. This Guide recommends that security rights that are effective against third parties generally should continue in property that has become attached to other property, into manufactured products and into commingled property (see A/CN.9/631, recommendations 35, subpara. (b), and 40-45). Where States permit continued third-party effectiveness of security rights in items of tangible property that are attachments, are manufactured products or commingled property, they normally also apply the general rules to enforcement against this type of

property (e.g. automobile engines, manufactured fibreglass products, commingled inventories of clothing, grain in a silo and oil in a tank). The assumption is that it would create unnecessary confusion if an enforcement regime other than that generally applicable were to be enacted. The Guide implicitly adopts a similar rule for enforcement against security rights in attachments that are effective as against third parties.

[Note to the Commission: The Commission may wish to consider adding a recommendation that specifically addresses enforcement of security rights in attachments.]

94. In cases of attachment, manufacture and commingling, it will normally be the case that more than one secured creditor will have rights in the property. If the encumbered asset can be easily separated, the secured creditor with an enforceable security right against only a part of the property should be able to separate the part in which it has a security right and dispose of that part only in a commercially reasonable manner. If the encumbered asset cannot be easily separated, the whole asset may have to be sold and the rights of competing secured creditors that may have rights in the property to which the attachment is attached will be determined by recommendations relating to priority (see A/CN.9/631, recommendation 95). Similarly, if a proportionate share of commingled assets cannot easily be isolated for separate sale, the whole mass or product may have to be sold and the rights of competing secured creditors that may have rights in other parts of the commingled property will be determined by recommendations relating to priority (see A/CN.9/631, recommendations 96-98).

[Note to the Commission: The Commission may wish to consider adding a recommendation that specifically addresses how enforcement of security rights in attachments and commingled property is to be effected depending on separability.]

10. Intersection of movable and immovable property enforcement regimes

95. Frequently, the characterization of tangible property as movable or immovable will change over time, as movable property becomes immovable property. For example, construction materials may become fully incorporated into a building, or shrubs and trees, manure and seeds may be planted or tilled into soil, thereby turning into immovable property. Sometimes, the movable property may be an attachment and not fully incorporated into immovable property (for example, an elevator, a furnace, or an attached counter or display case). In all of these cases, a security right in the movable property may have been made effective against third parties prior to attachment to or incorporation into the immovable property. The converse situation can also arise. A creditor may seek to take a security right in property that is currently immovable, but is destined to become movable (for example, crops, products of mines and quarries and hydrocarbons).

96. States have enacted many different rules to govern these various hypotheses. A primary concern is to establish the rights of creditors that seek to enforce security rights in movable property where immovable and movable property enforcement regimes may intersect. Most often, these enforcement regimes depend on the characterization given to the property. So, for example, many States permit the creation of a security right under secured transactions laws (applicable to movable property) in movable property that, while it is part of immovable property, is

destined to become movable, but postpone effectiveness until detachment. No enforcement of the security right can take place until the property becomes movable, and no enforcement of an encumbrance in immovable property may be taken against property that has become movable. While this Guide makes no specific recommendation on this question, because the enforcement regime presupposes the separate existence of tangible property as movable property such a result implicitly follows.

97. More difficult enforcement questions arise when tangible property is attached to or incorporated into immovable property. Many States distinguish between construction materials, other movable property that loses its identity when incorporated in immovable property (such as fertilizer), seeds, and attachments that retain their identity as movable property. Some States provide that security rights in movable property that loses its identity may only be preserved if they are made effective against third parties by registration in the immovable property registry, but that security rights in attachments made effective against third parties prior to the attachment retain their effectiveness without further registration. In these States, enforcement against the former kind of property would always be governed by the rules relating to enforcement against immovable property. Where the movable property becomes an attachment, these States usually enact special rules to govern not only the preservation of the secured creditor's rights, but also the preservation of the rights of creditors with rights in the immovable property.

98. The recommendations in this Guide follow the general pattern that many States have adopted for resolving conflicts between creditors with competing rights in attachments. Where tangible property loses its identity through incorporation into immovable property, any movable property security right is extinguished. Where, however, the movable property becomes an attachment, the security right continues, and its effectiveness against third parties is preserved automatically. The secured creditor may also ensure third-party effectiveness by registration of the security right in the immovable property registry (see A/CN.9/631, recommendations 35, 42 and 43). The enforcement rights of the secured creditor as against the attachment, and in relation to secured creditors that may have security rights in the immovable property, will then depend on the relative priority of the competing rights (see A/CN.9/631, recommendations 93 and 94). If the secured creditor with rights in the attachment has priority, it may detach the property and enforce its security right as a movable security right, subject to the right of the secured creditor or other interested party paying the value of the attachment. If, however, detachment of an attachment to immovable property (e.g. an elevator from a building) damages the building (not by diminishing its value), the secured enforcing creditor has to compensate persons with rights in the immovable property. If another creditor with a security right in the immovable property has priority, the secured creditor can enforce its rights only under the regime governing security rights in immovable property, provided that it has maintained effectiveness against third parties by registering in the immovable property registry (see A/CN.9/631, recommendations 161, subpara. (a), and 172).

99. The enforcement of security rights in attachments to immovable property is further complicated where the secured creditor has taken an encumbrance in the immovable property and a security right in the movable property that has become an attachment to the immovable property. Most States enable the creditor in such cases

to enforce the security in a variety of ways. The creditor may enforce the security right in the attachment and the encumbrance against the rest of the immovable property. Alternatively, the secured creditor may enforce the encumbrance against the entire immovable property, including the attachment. In the former case, the secured creditor would have to have priority over all rights in the immovable property (see A/CN.9/631, recommendation 172). In the latter case, the rights of the creditor would be determined by the priority regime governing immovable property (see A/CN.9/631, recommendation 161, subpara. (b)).

C. Recommendations

[Note to the Commission: The Commission may wish to note that, as document A/CN.9/631 includes a consolidated set of the recommendations of the draft legislative guide on secured transactions, the recommendations are not reproduced here. Once the recommendations are finalized, they will be reproduced at the end of each chapter.]

A/CN.9/631/Add.8 [Original: English]

**Note by the Secretariat on recommendations of the UNCITRAL draft Legislative
Guide on Secured Transactions, submitted to the Working Group on Security
Interests at its twelfth session**

ADDENDUM

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XI. Insolvency

A. General remarks

1. Introduction

1. Secured transactions laws and insolvency laws have different concerns and objectives, some of which may overlap where the interests regulated by a secured transactions law are affected by the commencement of insolvency proceedings. A secured transactions law seeks to promote secured credit, i.e. credit at a lower cost, because security lowers the risk of non-payment to the secured creditor (“default”). It allows debtors to use the full value of their assets to obtain credit, develop their businesses and avoid default. In the case of default by a debtor, a secured transactions law seeks to ensure that the value of the encumbered assets protects the secured creditor. It focuses on effective enforcement of the rights of individual creditors to maximize the likelihood that, if the obligations owed are not performed, the economic value of the encumbered assets can be realized to satisfy the obligations. An insolvency law, on the other hand, is principally concerned with collective business and economic issues. It seeks to maximize the return to all creditors, firstly by preventing a race among creditors to enforce individually their rights against a common debtor, and secondly by facilitating the reorganization of viable business enterprises and the liquidation of businesses that are not viable. For these reasons, an insolvency law may affect the rights of a secured creditor. For example, a secured creditor’s rights to enforce its security may be postponed upon the commencement of insolvency proceedings.

2. Since reform of one law can impose unforeseen transaction and compliance costs on stakeholders under the other law and create tension between the two laws, legislators revising existing laws or introducing a new law in the field of either insolvency or secured transactions will need to ensure that that new or revised law properly takes account of an existing or proposed law in the other field. In some cases, review of the law in one field may point to the need to revise or develop a new law in the other field. In any event, to the extent that an insolvency law affects

the rights of secured creditors, those effects should be based on carefully articulated policies and stated clearly in the insolvency law.

3. The effects of the commencement of insolvency proceedings on security rights are discussed in detail, as a matter of insolvency law, in the *UNCITRAL Legislative Guide on Insolvency Law* (hereinafter the “*Insolvency Guide*”), adopted by UNCITRAL on 25 June 2004.¹ The purpose of this chapter is to highlight, in section A, some of the key points of intersection between an insolvency law and a secured transactions law. To that end, recommendations from the *Insolvency Guide* that relate particularly to security rights are repeated in this Guide. For a more complete discussion of the potential effect of the commencement of insolvency proceedings on security rights, however, this chapter should be read together with both the commentary and the recommendations of the *Insolvency Guide*. This chapter also includes discussion of several additional recommendations elaborating on issues discussed in the *Insolvency Guide*, but not the subject of recommendations in that Guide. All the recommendations are set out in section B.

2. Terminology

4. The *Insolvency Guide* and the present Guide use a number of defined terms (see *Insolvency Guide*, Introduction, Glossary, and this Guide, Introduction, sect. B, Terminology and rules of interpretation). Section B of this chapter, which includes recommendations, also includes certain definitions taken from the *Insolvency Guide* that are useful for understanding the recommendations of that Guide. For a better understanding of the recommendations of the *Insolvency Guide*, reference should be made to the other definitions in that Guide.

5. Certain terms that are defined in the *Insolvency Guide* are not redefined in this Guide and thus have the same meaning as in the *Insolvency Guide*. However, since, unlike the *Insolvency Guide*, the focus of this chapter is on issues relating to security rights, terms that are redefined in this Guide have the meaning given to them in this Guide (for an exception, see paras. [8] and [9] below).

6. The term “security right” is used in this chapter as defined in this Guide, since the definition of “security interest” in the *Insolvency Guide* is broader in that it refers generally to “a right in an asset to secure payment or other performance of one or more obligations” and accordingly potentially covers security rights in immovable property and non-consensual security rights that are not covered by the definition of “security right” in this Guide (see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation).

7. Similarly, the term “priority” is used in this chapter as defined in this Guide, since the definition of “priority” in the *Insolvency Guide* is narrower, referring only to the priority of claims in the context of insolvency (“the right of a claim to rank ahead of another claim where that right arises by operation of law”). This Guide defines “priority” as “the right of a person to derive the economic benefit of its security right in an encumbered asset in preference to a competing claimant” (see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation).

¹ For the decision of the United Nations Commission on International Trade Law and the resolution of the General Assembly (resolution 59/40 of 2 December 2004), see the *UNCITRAL Legislative Guide on Insolvency Law* (United Nations publication, Sales No. E.05.V.10), annex II. The *Insolvency Guide*, which includes in its annex III the UNCITRAL Model Law on Cross-Border Insolvency and its Guide to Enactment, can be found at www.uncitral.org.

To refer to “priority” in insolvency proceedings, this chapter uses the term “ranking of claims” (see, for example, paras. [60]-[65] below).

8. The term “debtor” is defined in this Guide by reference to the person owing the secured obligation. As that definition would not work well in this chapter, “debtor” in this chapter has the meaning given to the term in the *Insolvency Guide*, that is, a person that meets the requirements for the commencement of insolvency proceedings (see *Insolvency Guide*, part two, chap. I, paras. 1-11, and recommendation 8).

9. In addition, as other chapters of this Guide focus on the term “grantor” (i.e. the person that creates a security right) rather than the term “debtor” (i.e. the person owing the secured obligation), references in this chapter to “debtor” should be understood as meaning “the grantor” in cases where the grantor is a person other than the person owing the secured obligation. This approach is necessary, since only in the third-party grantor’s insolvency does the secured creditor have a proprietary right in the encumbered assets. In the insolvency of a non-grantor debtor, the creditor is an unsecured creditor with an unsecured claim against the non-grantor debtor.

3. General principles concerning security rights in insolvency

10. Consistent with the *Insolvency Guide*, insolvency law should recognize in principle the creation, third-party effectiveness and priority of a security right and post-default rights of a secured creditor, as established under secured transactions law (see recommendations 179 and 180 of this Guide). However, to achieve the goals of insolvency proceedings, the rights that a secured creditor has outside of insolvency proceedings may need to be modified or affected once the insolvency proceedings commence. In such a case, it is desirable that an insolvency law also include appropriate protections for the secured creditor. What is important for the availability of secured credit is that insolvency law contains clear rules as to the effect of insolvency proceedings on the rights of a secured creditor, so as to enable secured creditors to quantify the risks associated with insolvency and incorporate those risks into their assessment of whether to extend credit and on what terms.

4. Applicable law in insolvency proceedings

11. The determination of the law applicable to the creation, third-party-effectiveness and priority of a security right and the post-default rights of a secured creditor may be a complex issue when insolvency proceedings are commenced in one State and some of the debtor’s assets or creditors are located in another State, or when insolvency proceedings are commenced in two different States owing to the multinational nature of the debtor’s business. In either instance, general private international law rules applying outside of insolvency proceedings would govern these matters. This result is made clear in recommendation 30 of the *Insolvency Guide*, which provides that the State in which insolvency proceedings are commenced (i.e. the forum State) should apply its private international law rules to determine which State’s secured transactions law governs such questions as the creation, third-party effectiveness and priority of a security right and post-default rights of a secured creditor outside of insolvency proceedings (see also recommendation 173 of this Guide).

(a) Insolvency effects: *lex fori concursus*

12. Once, under the non-insolvency law applicable outside of insolvency proceedings by virtue of the private international law rules of the forum State, the creation, third-party effectiveness and priority of a security right and post-default rights of a secured creditor are determined, a second issue arises concerning the effect of commencement of insolvency proceedings on security rights. For example, the question arises as to whether enforcement of a security right is stayed and whether the security right will be recognized in the insolvency proceedings and, if so, its relative position. The problem in this second phase lies in determining the law applicable to these insolvency effects. It is generally recognized that the insolvency law of the State in which the insolvency proceedings are commenced (*lex fori concursus*) governs the commencement, conduct, administration and conclusion of the proceedings (the “insolvency effects”). This result is reflected in recommendation 31 of the *Insolvency Guide*.

13. Problems may arise when the insolvency law governing the ranking of the security right changes the relative priority that a security right would have under secured transactions law. The categories of claims that, under insolvency law, would receive distributions ahead of a security right in insolvency proceedings are typically governed by the *lex fori concursus*. When establishing these categories of claims, the insolvency law of a State should look to secured transactions law with regard to the creation, third-party effectiveness, priority and enforcement of the security right before considering the extent, if any, to which the priority of the security right should be affected by the commencement and administration of insolvency proceedings.

(b) Exceptions to the *lex fori concursus*

14. While the insolvency effects of insolvency proceedings on security rights typically are governed by the *lex fori concursus*, some States have adopted exceptions. For example, a forum State may defer to the insolvency law of the State in which immovable property is located (*lex rei sitae*) for the insolvency effects on a security right in attachments to the immovable property. The *Insolvency Guide* addresses these exceptions in more detail (see part two, chap. I, paras. 85-90), but does not recommend the adoption of a *lex rei sitae* rule for insolvency effects as applied to attachments to immovable property or even to movable property in general. Instead, it generally recommends that any exceptions to the applicability of the *lex fori concursus* for insolvency effects should be limited in number and clearly set forth in the insolvency law (see *Insolvency Guide*, recommendation 34 and part two, chap. I, para. 88).

15. The question of the applicable insolvency law is further complicated if the debtor is subject to concurrent insolvency proceedings commenced in different States. In such a case, the court in which one proceeding is pending may defer to the insolvency law of the State in which another proceeding is pending for the insolvency effects on a security right in an encumbered asset located in the other State.

5. Treatment of encumbered assets

16. A security right may be affected following the commencement of insolvency proceedings by the provisions of insolvency law that define the scope of or otherwise address, for example, the assets of the debtor that are subject to the

insolvency proceedings, application of a stay or suspension of actions against the debtor, post-commencement finance, avoidance of transactions that took place before commencement of the proceedings, approval of a reorganization plan, and ranking of claims.

(a) Identification of assets subject to the proceedings

17. Identification of assets of the debtor that will be subject to insolvency proceedings is key to the successful conduct of the proceedings. Assets that are controlled by an insolvency representative and subject to the insolvency proceedings form the “estate” (see definition of the term “assets of the debtor” in sect. B below). So, the estate that is formed on commencement of the proceedings will typically include all property, rights and interests of the debtor, including rights and interests in property, whether tangible (movable or immovable) or intangible, wherever located (domestic or foreign), and whether or not in the possession of the debtor at the time of commencement. The debtor’s rights and interests in encumbered assets as well as assets acquired by the debtor or the insolvency representative after commencement of the proceedings and assets recovered through avoidance actions, would typically be included in the estate.

(i) Encumbered assets

18. The inclusion in the estate of the debtor’s rights and interests in encumbered assets may assist in ensuring not only the equal treatment of creditors similarly situated, but also the achievement of the goals of the insolvency proceedings where, for example, the asset in question is essential for the reorganization of the debtor or sale of the debtor’s business as a going concern. The *Insolvency Guide* discusses the assets of the debtor to be included in the estate (as well as those assets to be excluded) and the effect of commencement of insolvency proceedings on encumbered assets. It emphasizes, in particular, the importance to a successful reorganization of including in the insolvency estate the debtor’s interest in encumbered assets and third-party-owned assets (see *Insolvency Guide*, part two, chap. II, paras. 7-9) and of applying a stay on commencement to certain actions with respect to security rights (see *Insolvency Guide*, part two, chap. II, paras. 36-40, 56, 57 and 59-69, and recommendation 46, as well as paras. [25] and [26] below).

(ii) Assets acquired after commencement of insolvency proceedings

19. Consistent with the recommendations of the *Insolvency Guide* (see recommendation 35, subpara. (b)), an asset acquired by the debtor after the commencement of insolvency proceedings generally is part of the insolvency estate.

20. Accordingly, even though the secured creditor may have a security right in future assets of the debtor, the security right should not extend to an asset acquired by the debtor after the commencement of the insolvency proceedings (see also recommendation 176 of this Guide). If the security right did extend generally to an asset acquired by the debtor after the commencement of the insolvency proceedings, the secured creditor would unfairly benefit from the increase in the encumbered assets that could be available to satisfy the secured obligation resulting from the post-commencement acquisition of property by the debtor without the secured creditor providing any additional credit to the debtor. Likewise, other creditors of the insolvency estate would be unfairly prejudiced if unencumbered assets of the insolvency estate were used after the commencement of the insolvency proceedings

to acquire additional property and those assets were to become automatically subject to the secured creditor's security right and used to satisfy the secured obligation.

21. However, if the asset acquired by the debtor after the commencement of the insolvency proceedings consists of proceeds of an asset in which a secured creditor had a security right that was effective against third parties before the commencement of the insolvency proceedings (or was made effective against third parties after commencement but within a grace period), the security right should extend to the proceeds (see recommendation 177 of this Guide). If this were not the case, the secured creditor would not have the benefit of its security right in an encumbered asset that is disposed of or collected after the commencement of the insolvency proceedings and, because of that risk, would be less willing to extend credit at affordable rates to the debtor even where there is no likely prospect of the commencement of the debtor's insolvency proceedings.

22. An example may be helpful in illustrating these points. A secured creditor has an unavoidable security right in all of the debtor's existing and future inventory. After the commencement of insolvency proceedings, the debtor sells immovable property that is not subject to any security right and uses the cash received from the sale to buy inventory. The security right should not extend to this post-commencement inventory. The secured creditor advanced no credit in reliance upon a security right in the new inventory. Permitting the security right to extend to the new inventory would prejudice other creditors of the insolvency estate since the immovable property, an unencumbered asset that was otherwise available to satisfy claims of the other creditors, would have been used to increase the assets available to satisfy the secured obligation. The result would be that the value of the additional inventory would be less likely to be available to satisfy claims of the other creditors even though the value was derived from immovable property that was fully available to satisfy those claims.

23. However, if the additional inventory was acquired with cash received by the debtor from the sale of inventory existing on the commencement of the insolvency proceedings and in which the secured creditor had an unavoidable security right, the security right should extend to the inventory acquired after the commencement of the insolvency proceedings. Before the commencement of the insolvency proceedings the secured creditor had advanced credit to the debtor in reliance upon a security right in the inventory that the debtor sold after the commencement of the insolvency proceedings. The additional inventory is in effect a substitution for the sold inventory. The secured creditor does not benefit unfairly and other creditors are not unfairly prejudiced.

(b) Protection of the estate by application of a stay

24. Two essential objectives of an effective insolvency law are, first, ensuring that the value of the insolvency estate is not diminished by the actions of various parties and, second, facilitating administration of the estate in a fair and orderly manner. Many insolvency laws achieve these objectives by imposing a stay that prevents the commencement of individual or group actions by creditors to enforce their claims or pursue any remedies or proceedings against the debtor or property of the estate and suspends any such actions already under way. Where the stay applies from the commencement of the insolvency proceedings, it can be complemented by provisional measures of relief that can be ordered by the court to ensure protection of the assets of the debtor and the collective interest of creditors between the time when an application to commence insolvency proceedings has been filed and the

time it is acted on by the court. The *Insolvency Guide* discusses the scope of actions to which a mandatory or provisional stay applies (see *Insolvency Guide*, part two, chap. II, paras. 30-40); time and duration (including extension) of the stay (see part two, chap. II, paras. 41-53 and 58); and measures to protect the interests of secured creditors (part two, chap. II, paras. 59-69).

(i) *Scope of the stay*

25. A number of jurisdictions extend the stay to all actions against the debtor, whether judicial or not, including those by secured creditors and third-party owners. The stay usually extends to actions to enforce a security right by repossessing and selling, leasing or otherwise disposing of the encumbered assets (or exercising another enforcement remedy set out in chapter X, Post-default rights, of this Guide). It also extends to actions to create a security right or to make a security right effective against third parties. Some insolvency laws distinguish between liquidation and reorganization in terms of application and duration of the stay to actions by secured creditors or third-party owners. A growing number of insolvency laws recognize that, notwithstanding that limiting the enforcement of security rights may have an adverse impact on the cost and availability of credit, excluding actions by secured creditors from the stay could frustrate the basic objectives of the insolvency proceedings. This is true particularly in reorganization, since very often the debtor's continued use of encumbered assets is essential to the operation of the business and therefore to its reorganization. Any negative effects of the stay can be ameliorated by measures to ensure that the economic value of the encumbered assets is protected against diminution (see paras. [29]-[31] below).

26. Where a security right was effective against third parties at the time the insolvency proceedings commenced, it is necessary to exempt from the application of the stay any action that the secured creditor might need to take to ensure that effectiveness continues. For example, the secured transactions law may provide a grace period for registration of certain security rights, such as acquisition security rights, in the general security rights registry (see recommendation 189, subpara. (b), of this Guide); the stay generally should not interfere with registration within such a grace period (even if the grace period ends after the commencement of the insolvency proceedings).

(ii) *Duration of the stay*

27. In reorganization proceedings, subject to the safeguards discussed below it is desirable that the stay applies to secured creditors for a sufficient period of time to ensure orderly administration of the reorganization without encumbered assets being removed from the estate before it can be determined how those assets should be treated and an appropriate plan approved.

28. It is also desirable that the stay applies to secured creditors in liquidation proceedings, in particular to facilitate sale of the business as a going concern. The stay may apply for a short period of time (e.g. 30-60 days) that is clearly set forth in the insolvency law, with provision for an extension in certain circumstances. Alternatively, the stay may apply for the duration of the liquidation proceedings, subject to the court providing relief in certain circumstances (see *Insolvency Guide*, recommendation 49).

(iii) *Protection of secured creditors*

29. An insolvency law should include safeguards to protect secured creditors where the economic value of their security rights is adversely affected by the stay. One of those safeguards may take the form of relief from the stay or a release of the encumbered asset. Even absent a request for relief from the stay, it is desirable that an insolvency law provides that a secured creditor is entitled to protection against the diminution in value of the encumbered asset and that the court may grant appropriate measures to ensure that protection (see *Insolvency Guide*, recommendation 50).

30. Grounds for relief from the stay or release of the encumbered asset might include cases where, for example, the encumbered asset is not necessary to a prospective reorganization or sale of the debtor's business; the value of the encumbered asset is diminishing as a result of the commencement of the insolvency proceedings and the secured creditor is not protected against that diminution of value; and, in reorganization, a plan is not approved within any applicable time limit. Some insolvency laws also provide that, once relief is granted and the stay has been lifted with respect to particular encumbered assets, the assets may be released to the secured creditor. In such an event, the secured creditor would be free to enforce its security rights under applicable law other than insolvency law. Any surplus value remaining after payment of the secured obligation would be part of the estate.

31. Central to the notion of protecting the value of encumbered assets from diminution is the mechanism for determining both the value of those assets and the time at which valuation takes place, depending upon the purpose for which the determination is required. Assets may need to be valued at different times during the insolvency proceedings, such as at commencement with the value being reviewed during the proceedings, or during the course of the proceedings. The basis on which the valuation should be made is also an issue (e.g. going concern or liquidation value). The value of an encumbered asset may, at least in the first instance, be determined by pre-commencement agreement of the parties or may require determination by the court on the basis of evidence, including a consideration of markets, market conditions and expert testimony.

32. The *Insolvency Guide* discusses the timing of valuation and different valuation mechanisms (see *Insolvency Guide*, part two, chap. II, paras. 66-68).

(c) **Use and disposal of encumbered assets**

33. Secured creditors will have an interest in the manner in which encumbered assets are treated following commencement of insolvency proceedings and, in particular, the use and disposal of those assets.

34. Where the insolvency estate includes the debtor's rights in encumbered assets, treatment of those assets will depend on the provisions of the insolvency law with respect, for example, to application of the stay, further encumbrance of those assets, use of the assets during the course of the insolvency proceedings, sale or disposal of assets, relinquishment of assets and sale of encumbered assets free and clear of any security rights. Some insolvency laws, for example, provide that only the insolvency representative may dispose of encumbered assets in both liquidation and reorganization proceedings. Other laws provide that the insolvency representative's ability to dispose of encumbered assets in liquidation proceedings is time-limited

and, once the relevant time period expires, the secured creditor may exercise its rights.

35. The *Insolvency Guide* discusses the conditions under which encumbered assets may be sold free of security rights (for example, the condition that the security right in an asset extends to the proceeds of the sale of the asset) and the protections to be afforded to secured creditors whose encumbered assets are so sold, including the need to notify secured creditors about any proposed sale or other disposal of encumbered assets and to give them an opportunity to object (see *Insolvency Guide*, part two, chap. II, paras. 74-89).

6. Post-commencement finance

36. In both liquidation and reorganization proceedings, an insolvency representative may require access to funds to continue to operate the business. The estate may have insufficient liquid assets to fund anticipated expenses, in the form of cash or other assets that will be converted to cash (such as anticipated proceeds of receivables) and that are not subject to pre-existing security rights effective against third parties. Where there are insufficient unencumbered liquid assets or anticipated cash flow, the insolvency representative must seek financing from third parties. Often, these parties are the same lenders that extended credit to the debtor prior to the commencement of insolvency proceedings, and typically they will only be willing to extend the necessary credit if they receive appropriate assurance (either in the form of a priority claim on, or priority security rights in, the assets of the estate) that they will be repaid.

37. In any of these financing arrangements (referred to collectively as “post-commencement finance”), it is essential that the rights of pre-commencement secured creditors in the economic value of the encumbered assets be appropriately protected against diminution (provided that the security right was effective against third parties prior to commencement or after commencement but within a grace period). While some countries permit, in limited circumstances, the creation of a security right to secure post-commencement finance that ranks ahead of a pre-existing security right, the creation of such a security right (sometimes referred to as a “priming lien”) should be permitted only where certain conditions are met, including that the rights of pre-commencement secured creditors in the economic value of the encumbered assets are protected against diminution. Post-commencement finance is addressed in some detail in part two, chap. II, paras. 94-107 of the *Insolvency Guide*.

7. Treatment of contracts

(a) Automatic termination or acceleration clauses

38. Parties to security agreements have an interest in the treatment in insolvency of clauses that define events of default giving rise to automatic termination or acceleration of payments under the agreement. Although some insolvency laws permit those clauses to be overridden when insolvency proceedings commence, this approach has not yet become a general feature of insolvency laws. The inability to interfere with general principles of contract law in this way, however, may make reorganization impossible where the contract relates, for example, to an asset that is necessary for reorganization or the sale of a business as a going concern.

39. Any negative impact of a policy of overriding these types of clause can be balanced by providing compensation to creditors that can demonstrate they have suffered damage or loss as a result of a contract continuing to be performed after commencement of insolvency proceedings. In addition, an exception to a general override of such clauses for certain types of contract could be included. The insolvency law could provide, for example, that such a clause does not render unenforceable or invalidate a contract clause relieving a creditor from an obligation to make a loan or otherwise extend credit or other financial accommodations for the benefit of the debtor after the commencement of the insolvency proceedings.

40. However, if the contractual clause in question relates to an obligation of the party not subject to the insolvency proceedings to make additional loans or other financial accommodations to the debtor, the other party should be relieved of that obligation. It would not be equitable to require additional loans to an insolvent party where the prospect of repayment would be greatly diminished. Requiring the extension of credit after commencement of insolvency proceedings would be especially inequitable if, as described in paragraph [20], no additional encumbered assets are being provided after commencement to the secured creditor. The obligation to make additional loans differs from other contractual obligations where the other party can expect or make arrangements for return performance by the debtor or its insolvency representative (see recommendation 178 of this Guide).

(b) Continuation or rejection of contracts

41. Insolvency laws adopt different approaches to continued performance or rejection of contracts. The *Insolvency Guide* considers a number of the issues relating to the treatment of contracts once insolvency proceedings commence, including the procedures for determining whether contracts should continue to be performed or rejected, treatment of contracts where the debtor is in default on commencement of insolvency proceedings, effects of continuing performance or rejection, leases, assignment of contracts, types of contract for which exceptions might be required and post-commencement contracts (see *Insolvency Guide*, part two, chap. II, paras. 108-147). In any case, what is important for a secured creditor is that rejection of a security agreement does not terminate or otherwise impair the secured obligations already incurred or extinguish the security right and that financial contracts and loan commitments are frequently excepted from the scope of insolvency laws governing the treatment of contracts more generally (see *Insolvency Guide*, part two, chap. II, paras. 208-215).

8. Avoidance proceedings

42. As mentioned above, insolvency law recognizes in principle the effectiveness of a security right, which is a matter of secured transactions law. Nevertheless, the security right may be avoidable in insolvency proceedings on the same grounds that any other transaction may be avoided. For example, the transaction may be avoided as a preferential transaction, an undervalued transaction, or as a transaction intended to defeat, hinder or delay creditors from collecting their claims. Otherwise, the debtor could encumber its assets to prefer one creditor to another on the eve of the commencement of insolvency proceedings, or without obtaining corresponding value, to the detriment of other creditors. The *Insolvency Guide* discusses categories of transactions subject to avoidance, the suspect period, conduct of avoidance proceedings and liability of counterparties to avoided transactions (see part two, chap. II, paras. 148-203).

43. Examples of security rights that may be subject to avoidance include a security right created shortly before the commencement of insolvency proceedings to secure a pre-existing debt; a security right with respect to which one or more of the steps required to make it effective as against third parties have been taken after the creation of the security right, and after the expiry of any grace period for doing so (see recommendation 189, subpara. (b), of this Guide) but within the suspect period; and the acceptance of an encumbered asset in total or partial satisfaction of the secured obligations (see recommendation 148 of this Guide) at a price significantly lower than the asset's actual value.

9. Participation of secured creditors in insolvency proceedings

44. Where encumbered assets are part of the insolvency estate and the rights of secured creditors are affected by insolvency proceedings, secured creditors should have a right to participate in the insolvency proceedings. In some cases, the extent of a secured creditor's right to vote on certain issues may depend upon the amount by which the secured obligation exceeds the value of the encumbered assets. The extent of such participation may be prescribed by an insolvency law and may include voting on issues specified by the insolvency law, such as selection (and removal) of the insolvency representative; approval of a reorganization plan; and sale of assets outside the debtor's ordinary course of business.

45. The *Insolvency Guide* discusses issues of participation of creditors generally and mechanisms that may be used to facilitate that participation (see part two, chap. III, paras. 75-115).

10. Reorganization proceedings

(a) Approval of a reorganization plan

46. Whether or not a secured creditor is entitled to participate in the approval of a reorganization plan will depend upon the manner in which the insolvency law treats secured creditors and, in particular, the extent to which a reorganization plan can modify or impair their security rights. The value of the encumbered asset in relation to the claim will determine whether the creditor participates as a secured, and also as an unsecured, creditor.

47. Where a reorganization plan proposes to impair or modify the rights of secured creditors, they should have the opportunity to vote on approval of that plan. For that purpose, some insolvency laws classify creditors, including secured creditors, according to the nature of their rights and interests. Under some laws, secured creditors vote together as a class separate from unsecured creditors; under others, each secured creditor forms a class of its own. The *Insolvency Guide* discusses reorganization proceedings in some detail (see *Insolvency Guide*, part two, chap. IV, paras. 26-75), including voting by secured creditors (see *Insolvency Guide*, part two, chap. IV, paras. [38]-[44]).

48. Where secured creditors participate in the approval process, there is a question of whether they are bound by the plan even if they vote against it or abstain from voting. Where secured creditors vote in classes, some insolvency laws provide that, to the extent that the requisite majority of the class votes to approve the plan, dissenting members of the class are bound by the plan, subject to certain protections (e.g. they receive at least as much under the plan as they would have received in a liquidation or they are paid in full within a certain period of time with interest at a

market rate). Other insolvency laws provide that the court can order that secured creditors are bound by the plan, provided that it is satisfied as to certain conditions (e.g. security rights are adequately protected and the position of the secured creditor will not deteriorate further as a result of the plan). Yet other insolvency laws provide that the plan cannot be imposed on a secured creditor unless the secured creditor, or the relevant class of secured creditors, consents.

49. There are several examples of ways in which the economic value of security rights may be preserved in a reorganization plan even though the security rights are being impaired or modified by that plan. If a plan provides for a cash payment to a secured creditor in total or partial satisfaction of the secured obligation, the cash payment or, if cash payments are to be made in instalments, the present value of the cash payments should not be less than what the secured creditor would have received in liquidation. In determining such value, consideration should be given to the use of the assets and the purpose of the valuation. The basis of such a valuation may include not only the strict liquidation value, but also the value of the asset as part of the business as a going concern. For example, if the debtor is going to retain possession of and continue to use the asset under the reorganization plan in order to continue to operate the business as a going concern or if the debtor is going to sell the business as a going concern, this value should be determined by reference to the value of the asset as part of the going concern business rather than the value of the asset as a single item separate from the business.

50. If the plan provides for the secured creditor to release its security right in some encumbered assets, provision could also be made for substitute assets of at least equal value to become subject to the secured creditor's security right, unless disposal of the remaining encumbered assets would enable the secured creditor to be paid in full.

(b) Valuation of encumbered assets

51. Recommendations 49, subparagraph (c)(ii), 50, 51, subparagraph (b), 54, subparagraph (a), 58, subparagraph (d), 59, subparagraph (c), and 67, sub-paragraph (c), of the *Insolvency Guide* provide generally for the value of encumbered assets to be protected in insolvency proceedings. Recommendation 152, subparagraph (b), of the *Insolvency Guide* provides that, under a plan confirmed by a court, each creditor, including a secured creditor, should receive at least as much under the plan as the creditor would have received in liquidation. Issues to be considered in determining the value of encumbered assets are discussed in the *Insolvency Guide* (see *Insolvency Guide*, part two, chap. II, paras. 66-69, and para. 31 above).

52. In order to determine the liquidation value of encumbered assets in reorganization proceedings (for the purpose of applying recommendation 152, subpara. (b) of the *Insolvency Guide*), the use of the encumbered assets and the purpose of the valuation should be taken into account. The liquidation value of the assets may be based on their value as part of a going concern (see recommendation 183 of this Guide).

53. For example, if the debtor is going to retain or dispose of the encumbered assets as part of a going concern sale of the debtor's business, the going concern value of the encumbered assets in the hands of the debtor, if higher than the liquidation value of the encumbered assets separate from being used in the going

concern, may better represent a truer value of the encumbered assets given the purposes for which the encumbered assets are to be used.

54. The going concern value may also be the value on which the secured creditor relied in advancing credit to the debtor before the commencement of the insolvency proceedings. The secured creditor may have advanced credit based on the encumbered assets being used in the business as a going concern and generating the necessary profits to repay the secured creditor.

11. Expedited reorganization proceedings

55. In recent years, significant attention has been given to the development of expedited reorganization proceedings (i.e. proceedings commenced to give effect to a plan negotiated and agreed to by affected creditors in voluntary restructuring negotiations that took place prior to commencement of insolvency proceedings, where the insolvency law permits the court to expedite the conduct of those proceedings). Voluntary restructuring negotiations undertaken before the commencement of proceedings will generally involve those creditors, including secured creditors, whose participation is required to ensure an effective reorganization or whose rights are to be affected by the reorganization.

56. The substantive requirements for such expedited reorganization proceedings would include substantially the same safeguards and protections as provided in full, court-supervised reorganization proceedings. However, since the reorganization plan has already been negotiated and agreed to by the requisite majority of creditors at the time the expedited proceedings commence, a number of the procedural provisions of an insolvency law relating to full court-supervised proceedings may be modified or need not apply (see *Insolvency Guide*, part two, chap. IV, paras. 87-92).

12. Treatment of secured claims

57. The principal issue with regard to deciding which creditors will be required to submit claims in insolvency proceedings relates to the treatment of secured creditors. Under those insolvency laws which do not include encumbered assets in the insolvency estate and allow secured creditors to freely enforce their security rights against the encumbered assets, secured creditors may be excepted from the requirements to submit a claim, to the extent that their claim will be met from the value of the sale of the encumbered asset (see *Insolvency Guide*, part two, chap. V).

58. Another approach requires secured creditors to submit a claim for the total value of their security rights irrespective of whether any part of the claim is unsecured. That requirement is limited in some laws to the holders of certain types of security right, such as floating charges, bills of sale, or security over chattels. Some insolvency laws also permit secured creditors to surrender their security rights to the insolvency representative and submit a claim for the total value of the secured obligation. The rationale of requiring secured creditors to submit claims is to provide information to the insolvency representative as to the existence of all claims, the amount of the secured obligation and the description of the encumbered assets. Whichever approach is chosen, it is desirable that an insolvency law include clear rules on the treatment of secured creditors for the purposes of submission of claims.

59. Where the amount of the claim cannot be, or has not been, determined at the time when the claim is to be submitted, many insolvency laws allow a claim to be

admitted provisionally, subject to giving it a notional value. Determining a value for such claims raises a number of issues such as the time at which the value is to be determined and whether it must be liquidated (in which case it will need to be considered by a court) or estimated (which might be undertaken by the insolvency representative, the court or some other appointed person). Where a court is required to determine the issue, an associated question relates to the court that will be appropriate (i.e. the insolvency court or some other court) and how any delay in reaching a determination can be addressed in terms of its effect on the conduct of the insolvency proceedings. As to timing of the valuation, many insolvency laws require it to refer to the effective date of commencement of proceedings (see *Insolvency Guide*, part two, chap. V, para. 38).

13. Ranking of secured claims

60. A secured transactions law establishes the priority of security rights as against competing claimants (for the definition of the terms “competing claimant” and “priority”, see A/CN.9/631, Introduction, sect. B, Terminology and rules of interpretation), including the debtor’s other secured and unsecured creditors, judgement creditors with a right in encumbered assets and buyers of encumbered assets. Many insolvency laws recognize the pre-insolvency priority of security rights and rank secured claims ahead of administration expenses and other claims (e.g. for taxes or wages). However, where the insolvency representative has expended unencumbered resources of the estate in maintaining or preserving the value of the encumbered assets, those expenses may be given a higher ranking even over a secured claim and, accordingly, may have to be paid out of the proceeds from the sale of or other value attributable to the encumbered assets (see recommendation 182 of this Guide).

61. Other insolvency laws rank secured claims after administration costs and other specified (and generally unsecured) claims (e.g. for wages or taxes) or limit the amount with respect to which a secured claim will be given a higher ranking to a fixed percentage of the claim.

62. The provision of higher ranking for certain unsecured claims, which is often based on social policy considerations, has an impact upon the cost and availability of secured credit. The approach of restricting the amount recovered by a secured creditor from the value of the encumbered assets is sometimes taken with respect to a security right in the entirety of a debtor’s assets in order to provide some protection to unsecured creditors (often up to a limited amount).

63. A further approach may permit the ranking of post-commencement secured creditors ahead of the rights of secured creditors existing at the time of commencement (see paras. 36 and 37 above), provided the security rights of pre-existing creditors can be protected.

64. It is desirable that situations in which an insolvency law creates special privileges for certain types of claims ranking ahead of security rights (for example, a privilege for payment of tax or other unsecured claims), those privileges be kept to a minimum and clearly stated or referred to in the insolvency law (see recommendation 180 of this Guide). This approach will ensure that the insolvency regime is transparent and predictable as to its impact on creditors and will enable secured creditors to assess more accurately the risks associated with extending credit. These issues are discussed in more detail in the *Insolvency Guide*, part two, chapter V, paragraphs 51-79.

65. As already mentioned, insolvency law usually respects the pre-commencement priority of a security right (where the security right was made effective against third parties prior to commencement or after commencement but within a grace period), subject to any privileges for other claims that may be introduced by insolvency law. The same applies to priority of security rights established by subordination (i.e. a change of priority of a security right by agreement, by order of a court or even unilaterally; see recommendation 181 of this Guide). However, subordination should not result in a secured creditor being accorded a ranking higher than its ranking, whether as an individual creditor or as a member of a class of secured creditors, under applicable law. This means that, if secured creditors A, B and C rank in priority so that A is first, B is second and C is third, and A subordinates its secured claim to that of C, B does not obtain a ranking higher than A would have had with respect to the amount of A's claim. It also means that a secured creditor obtaining a subordination from a secured creditor within a class cannot obtain a ranking higher than the ranking of the class.

14. Acquisition financing transactions

66. The treatment in insolvency of security rights and other rights that function so as to secure the performance of an obligation is a key concern of a buyer's, lessee's or borrower's creditors. This treatment can sometimes vary considerably depending on how any particular right is characterized. Generally, but not universally, in legal systems that do not treat retention-of-title transactions and financial leases as security devices, a contract of sale with a retention-of-title clause or a financial lease contract is treated in the insolvency of the buyer or lessee under the rules relating to partly performed contracts (or, in other words, as title devices).

(a) Assets subject to an acquisition security right (unitary approach)

67. In States that integrate all forms of acquisition financing rights into their secured transactions law, retention-of-title transactions and financial leases are treated in the debtor's insolvency in the same way as a non-acquisition security right, with recognition given to any special priority status accorded to the acquisition security right under non-insolvency law (see recommendation 174, unitary approach, of this Guide). As a result, the provisions of the *Insolvency Guide* applicable to security rights would apply to acquisition security rights (for the definitions of the terms "security right", "acquisition financing right", "retention of title" and "financial lease" and other relevant terms, see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation).

(b) Assets subject to an acquisition financing right (non-unitary approach)

68. The same consequence as noted in paragraph [67] is produced in some States that maintain separately denominated retention-of-title transactions and financial leases but subject them and similar arrangements to the same rules that apply to non-acquisition security rights, with recognition given to any special priority status accorded to the acquisition security right under non-insolvency law (recommendation 174 (alternative A), non-unitary approach, of this Guide).

69. Where an acquisition security right is treated in the same way as an ordinary (non-acquisition) security right, typically the insolvency representative can use, sell or lease the encumbered assets so long as it gives substitute assets to the secured creditor or the value of the secured creditor's right in the property is otherwise

protected against diminution. In such situations, any portion of the secured obligations in excess of the value of the secured creditor's right in the property is treated as a general unsecured claim, and in the grantor's reorganization the secured creditor's claim, up to the value of the security right, can be restructured (as is the case with other non-purchase acquisition security rights) with a different maturity, payment schedule, interest rate and the like.

70. Where retention-of-title transactions and financial leases are treated as partly performed contracts (or title devices), the insolvency representative has the right, within a prescribed time period and if willing and able to do so, to perform the contract by (a) paying the outstanding balance of the price and bringing the property into the estate; or (b) continuing to pay the lease payments as they come due. In some cases, the insolvency representative can assign the contract, together with the right to use the property (which in the case of a lease may require the consent of the lessor) to a third party. Alternatively, the insolvency representative can reject the contract, return the property and claim the return of the part of the purchase price paid by the buyer subject to a deduction for depreciation and use prior to the insolvency. In the case of a lease, the insolvency representative can repudiate the lease for the future and return the property to the lessor. However, if the property is critical to the success of the buyer's reorganization, only the first option (performance of the contract as agreed) would in practice be available to the insolvency representative. The need for the insolvency representative to perform the contract as agreed may, for example in cases where the current value of equipment is less than the balance of the purchase price, result in other assets of the insolvency estate being used to satisfy that performance rather than being used to fund other aspects of the reorganization of the grantor (see recommendation 174 (alternative B), non-unitary approach, of this Guide).

71. If retention-of-title and similar arrangements like financial leases are treated as partly performed contracts (or title devices), the retention-of-title seller and the financial lessor will have stronger rights at the expense of other creditors of the insolvency proceedings. The exercise of the stronger rights might result in some reorganizations not being successful, with possible loss of jobs and with other creditors of the insolvency estate not obtaining as much of a recovery on their claims. Thus, a State considering the treatment of retention-of-title, financial leases and the like in insolvency proceedings should consider whether the State's policy of encouraging the manufacture, supply and financing of equipment or inventory through the strengthening of the rights of retention-of-title sellers and financial lessors outweighs or is subordinate to the State's policy favouring reorganization proceedings.

72. In any case, regardless of whether an acquisition financing right is treated in the insolvency proceedings under the rules applicable to security rights or under the rules applicable to contracts and third-party-owned assets, all acquisition financing rights should be subject to the insolvency effects specified in the *Insolvency Guide*. With either type of non-unitary approach, it may be important to note that the *Insolvency Guide* often recommends the same treatment for the holders of security rights and third-party-owned assets, including those set forth in recommendation 88 of the *Insolvency Guide* (regarding the application of avoidance powers to, among other things, security rights and acquisition financing rights that are not effective against third parties, whether by the filing of a notice in the general security rights registry or otherwise); recommendation 35 (regarding the inclusion of the debtor's rights in encumbered assets and assets subject to acquisition financing rights within

assets constituting the insolvency estate); recommendations 39-51 (regarding the application of provisional measures and a stay to encumbered assets and assets subject to acquisition financing rights and relief from the stay); recommendation 52 (regarding use and disposal of assets of the estate, including encumbered assets and the debtor's rights and interests in assets subject to acquisition financing rights); recommendation 54 (regarding the use of third-party-owned assets); and recommendations 69-86 (regarding the treatment of contracts). Recommendation 35, footnote 6, of the *Insolvency Guide*, which was drafted before finalization of this Guide, is understood to apply to all acquisition financing rights determined by reference to relevant applicable law, whether based on ownership or otherwise.

15. Receivables subject to an outright transfer before commencement

73. An outright transfer of a receivable (i.e. a transfer of a receivable not for security) is within the scope of the present Guide (see recommendation 3 of this Guide); a "security right" is defined to include an outright transfer of a receivable (see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation). In referring to an outright transfer, this Guide does not affect the application of any rule under law other than insolvency law by which a transaction may be re-characterized as a transfer for security even though the parties denominated the transaction as an outright transfer. In the event of such a re-characterization, the transfer would not qualify as an outright transfer for the purposes of this Guide.

74. If a security right in a receivable created by the debtor before the commencement of the debtor's insolvency proceedings is treated, under law other than insolvency law, as an outright transfer of the receivable, insolvency law should treat the outright transfer of the receivable as it would treat a pre-commencement transfer by the debtor of any other asset where the transfer qualifies as an outright transfer under law other than the insolvency law and exclude the asset transferred outright before the commencement of the insolvency proceedings from the insolvency estate of the debtor (see generally *Insolvency Guide*, recommendation 35, subpara. (a)).

75. However, as with the pre-commencement outright transfer by the debtor of any other asset and, indeed, as with any other pre-commencement transaction, the outright transfer of the receivable is nevertheless subject to the avoidance rules of the insolvency law (see *Insolvency Guide*, recommendation 88). For example, the transfer may be avoided, and the receivable may be brought into the insolvency estate, if (a) the transfer was not effective against third parties at the time of commencement of the insolvency proceedings; (b) the transfer could be avoided under the avoidance rules of the insolvency law relating to undervalued transactions; or (c) in the event that the transfer occurred on one date but was not made effective against third parties until a later date outside of any grace period and during the suspect transfer period, under the avoidance rules of the insolvency law relating to suspect transfers.

76. If the receivable is not in the insolvency estate and is not brought into the estate under the avoidance rules of the insolvency law, then, because the transferee is the owner of the receivable, any stay arising under the insolvency law should generally not apply to the collection of the receivable by the transferee and the insolvency law should generally not apply to the receivable or to the transferee's collection of the receivable. Nevertheless, if, pursuant to a contract in effect at the time of the commencement of the insolvency proceedings, the debtor has been

engaged by the transferee to collect the receivable for the benefit of the transferee, any stay under the insolvency law that is applicable with respect to contracts with the debtor generally (and thus applicable to that engagement contract) would, on that basis and notwithstanding the transferee's ownership of the receivable, prevent the transferee from collecting the receivable or otherwise interfering with the engagement contract until the termination of the stay as to the engagement contract or the rejection by the debtor of the engagement contract (see recommendation 175 of this Guide).

B. Recommendations

[Note to the Commission: The Commission may wish to note that, as document A/CN.9/631 includes a consolidated set of the recommendations of the draft legislative guide on secured transactions, the recommendations are not reproduced here. Once the recommendations are finalized, they will be reproduced at the end of each chapter.]

A/CN.9/631/Add.9 [Original: English]**Note by the Secretariat on recommendations of the UNCITRAL draft Legislative Guide on Secured Transactions, submitted to the Working Group on Security Interests at its twelfth session****ADDENDUM****CONTENTS**

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XII. Acquisition financing rights

A. General remarks

1. Introduction

(a) Meaning of acquisition financing transactions

1. The purchase and sale of tangible property (for the definition of “tangible property”, see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation) is a central activity of many businesses. Sometimes, this involves the acquisition of raw materials and their subsequent manufacture and sale. Sometimes, it involves the purchase of inventory at wholesale for distribution to retailers or for resale at retail. In addition, for many businesses, the extraction and processing of raw materials or the display and distribution of inventory requires substantial investment in costly equipment. Most often these raw materials, inventory and equipment are purchased on credit.

2. Whenever a business acquires the ownership (or title) or the right to use, transform and dispose of raw materials, inventory or equipment on credit and offers rights in the property being acquired as security for the credit being extended, it is engaged in a particular form of secured transaction, which this Guide calls an acquisition financing transaction. The right that the seller or creditor retains or obtains in the property that is supplied to the buyer or grantor may be called, depending on their precise character, either “acquisition financing rights” or “acquisition security rights” (for the definitions of “grantor”, “acquisition financing right” and “acquisition security right”, see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation).

3. Acquisition financing transactions are among the most important sources of credit for many businesses. In many respects, they are identical to ordinary secured transactions as described in previous sections of this Guide. But in other respects, they have particular features that have led States to provide for special rules in several situations. This chapter considers the ways in which States may achieve an efficient and effective regime to govern all types of acquisition financing transaction.

4. Because of the number and diversity of acquisition financing transactions in use today it is important to state clearly how this Guide uses the term. An acquisition financing transaction exists wherever one person may claim a property right in tangible property to secure another person’s obligation to pay any unpaid portion of the purchase price (or its economic equivalent), whether that right exists in favour of a seller, a lessor or a lender. A transaction under which a seller retains property rights in the property sold for such a purpose is also an acquisition financing transaction. The key features of an acquisition financing transaction are two: (a) the credit is advanced for the specific purpose of enabling the buyer to acquire an item of tangible property; and (b) the acquisition financing rights retained or the acquisition security rights claimed relate directly to the property being acquired.

(b) Diversity of acquisition financing transactions

5. As noted in chapter III (Basic approaches to security) of this Guide, States have developed a wide variety of legal devices through which those that advance credit can ensure repayment of their debtor's obligation. While only some are classically known as security rights, all serve the economic function of securing the repayment obligation.

6. A similar, if not even greater, diversity of legal devices is typically available to those (often sellers) that finance a buyer's acquisition of tangible property. For example, a seller that retains title to the property being sold until the buyer has paid the purchase price in full (a retention-of-title seller), is extending credit terms to its buyer and is thereby financing the buyer's acquisition of that property. The retention-of-title right (for the definition of "retention-of-title right", see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation) is just one of several devices available to sellers. A seller may also transfer title to a buyer with a proviso that the buyer's title will be retroactively extinguished if it fails to pay the agreed purchase price (the sale is under a "resolutive condition"); or, a seller may transfer title to a buyer, but take a security right in the property being sold.

7. Sellers comprise just one category of financiers that may offer credit to enable a person to acquire a tangible object. Lenders also may provide credit to a buyer for the specific purpose of enabling that buyer to purchase property from a seller. Because both sellers and lenders may advance credit to enable buyers to acquire tangible objects it is possible for more than one person to be claiming an acquisition financing right or an acquisition security right in the same property.

8. Still another form of acquisition financing transaction may not even involve a contract of sale at all. A lessor that leases property to a lessee on terms that are equivalent to those of a sale on credit is likewise providing financing that enables the lessee to use the tangible property in the same manner as if it owned that property, even if title never passes from the lessor to the lessee. As in the case of sellers, there are different ways in which lessors may structure the agreement so as to create a financial lease, that is, a lease that enables the lessee to acquire the economic equivalent of an ownership right in the leased property (for the definition of "financial lease", see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation).

9. So also, a lender that provides credit to a lessee for the purpose of paying the rental payments as they come due under a lease may, depending on the terms of the credit, be an acquisition secured creditor with rights in the property being leased. If the credit being extended actually enables the lessee to conclude the financial lease agreement with the lessor, the lender is financing the lessee's use (and notional acquisition) of that property.

(c) Outline of the chapter

10. This chapter discusses, in section A.2, the commercial background of contemporary acquisition financing transactions, and in section A.3, the various approaches to acquisition finance that have heretofore been adopted in different legal systems. Section A.4 sets out the key policy choices that confront States enacting legislation to govern the various types of acquisition financing transaction.

The remainder of the chapter then reviews how the several components of a secured transactions regime discussed in other chapters of this Guide apply in the specific case of acquisition finance. It considers, in section A.5, the creation of such devices as between the parties, in section A.6, the effectiveness of such devices as against third parties, in section A.7, priority as against competing claimants, in section A.8, pre-default right and obligations of the parties, in section A.9, post-default rights of the parties, in section A.10, private international law, and in section A.11, transition issues. The chapter concludes, in section B, with a series of specific recommendations.

2. Commercial background

(a) General

11. The opening paragraphs of this chapter summarized a number of different ways for a buyer to finance the acquisition of tangible property, such as equipment and inventory. In this section, the commercial background of these various transactions and their actual operation are considered in greater detail.

12. An initial distinction to be drawn when considering the purchase and sale of tangible property in a commercial setting is that between cash sales and sales on credit. Sometimes buyers have sufficient liquidity that they may purchase both equipment and inventory on a cash basis. As a rule, however, commercial enterprises will acquire a substantial part of their raw materials, inventory and equipment on credit.

13. Acquisition credit will normally be of two types. First, a buyer might simply borrow the purchase price from a third party on an unsecured basis. For example, while the sale transaction is itself a cash transaction, it may be financed by a general line of credit from the primary lender of the business. This method is simple, but the buyer's credit rating or reputation might limit availability of such credit or make the cost of such third-party credit prohibitively high. Second, a buyer may agree with a seller to purchase the property on credit terms that allow the buyer to make payment (perhaps in instalments) after the completion of the sale. Here the seller transfers possession and ownership of the property to the buyer and is paid the purchase price in a lump sum at a later time, or through periodic instalment payments. This method, of course, is not really different to third-party finance except that the risk of non-payment is now on the seller rather than on a third-party financier. Many sellers are often unwilling to bear such an unsecured risk.

14. As a result, many buyers find that, as a practical matter, it is necessary to give some form of security in order to acquire tangible property on credit. The property subject to a security right could well be other property of the buyer. For example, a business would grant security over its factory or warehouse to secure repayment of a loan to be used to acquire inventory or raw materials. Typically, however, the most obvious asset on which security may be taken, and frequently the only such asset available to a buyer, is the property actually being acquired.

15. Property being acquired can be used as security for acquisition credit in several different ways. For example, in some legal systems, sellers have special rights that automatically enable them to cancel the sale and take back the property sold if the buyer does not pay the purchase price within a certain period after delivery. Similarly, other legal systems give sellers an automatic right to claim a

priority or preference in the distribution of proceeds of a sale of the property they have sold. Often, however, the security claimed by an acquisition financier does not arise by operation of law, but is the result of an agreement between the seller or lender and the buyer.

16. The creation by agreement of a security right in property being acquired by a buyer in order to ensure the payment of the purchase price can take many forms. For example, the buyer may formally grant a security right in the property to a third-party financier; or the buyer may formally grant such a security right to the seller; or the buyer and seller may agree to some other legal mechanism, which, although not in the form of a security right, is its economic equivalent. Two such mechanisms are (a) the use of ownership in the property to secure payment (typically, although not always, by a retention-of-title transaction); and (b) the use of a longer-term lease (typically through a financial lease transaction).

(b) Retention-of-title and similar transactions

17. A supplier of inventory or equipment may wish to meet its customer's need for credit by supplying the property to the customer under an agreement by which ownership of the property being sold does not pass to the buyer until the purchase price has been paid in full. In many cases the agreement is between the seller and the buyer without any intermediary. In some cases, however, the seller may sell the property for cash to a finance institution or other lender, which may then sell the property to the buyer under an agreement that enables it to retain ownership of the property until full payment of the purchase price.

18. There are many forms in which buyers and sellers may structure an agreement by which the seller reserves ownership of the property sold until full payment (retention-of-title agreements). The retention-of-title mechanism is very common. In this transaction a seller's right in tangible property is not transferred to the buyer until the condition that the unpaid portion of the purchase price of the property is paid in full has been satisfied. While the buyer usually obtains immediate possession of the property, ownership remains vested in the seller until the purchase price is paid.

19. Retention-of-title arrangements are sometimes called conditional sales. Generally, however, in transactions called "conditional sales" the sale itself is not conditional (that is, the actual sale agreement is not dependent on the occurrence of some event not related to the sale itself). Rather, under a "conditional sale", it is the transfer of ownership to the buyer that is conditional. The seller reserves ownership of the property sold until the purchase price has been paid in full or the buyer has complied with any other conditions prescribed in the sale agreement.

20. There are, of course, other types of transaction whereby a seller uses ownership of the property sold as security for the purchase price. For example, sometimes the reservation of a seller's ownership is structured as a sale with a term, and the transfer occurs only at the end of the stipulated term. Occasionally, a seller will actually transfer ownership to a buyer at the moment of sale, with a proviso that the buyer's title will be retroactively extinguished should it fail to pay the agreed purchase price according to stipulated terms.

21. In each of these cases, the key feature is that the agreement by the seller to postpone full payment is protected either by delaying the passing of title to the

property to the buyer or, less commonly, by transferring title to the buyer subject to the seller's right to regain title upon failure of the buyer to pay. The more common case (retention-of-title transactions) may, in some States, be varied through certain clauses that greatly expand its usefulness as an acquisition financing device. So, for example, the parties may be permitted to agree to an "all-monies" or "current-account" clause. Where such clauses are used, the seller retains ownership of the property sold until all debts owing from the buyer to the seller have been discharged (and not just those arising from the particular contract of sale in question).

22. In addition, in some States parties are permitted to add "products" clauses, in which the seller's ownership is extended to, or the seller is deemed to have a security right in, any products that are manufactured from the property in which the seller retained ownership. Similarly, some States allow for "proceeds" (for the definition of "proceeds", see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation) clauses under which sellers may claim ownership or a security right in any proceeds generated by the sale of the property in which the seller retained ownership (for the treatment of proceeds in the case of ordinary security rights, see A/CN.9/631, recommendations 18-20).

23. Often, however, the applicable law strictly limits the scope of the seller's retained ownership. In many States the right may be claimed (a) only upon the property sold (i.e. neither on proceeds nor on replacement property); (b) only so long as the property remains in its original condition (i.e. unaltered by the manufacturing process); (c) only to secure the sale price of the property; or (d) only when all the three former conditions are met.

(c) Financial leases and hire-purchase transactions

24. A supplier may also use the concept of a lease to enable businesses to acquire the use of property without having to pay its purchase price in cash. For example, a supplier of equipment may lease a piece of equipment to a business that takes possession of the equipment and makes monthly rental payments. In these agreements the supplier necessarily retains ownership of the equipment (as lessor) and the lessee merely pays the rent as it falls due.

25. In some cases, the lease agreement is structured to achieve the functional equivalent of an instalment sale. For example, the term of the lease may be for the useful life of equipment being sold and, at the end of the lease, the lessee automatically acquires ownership; or the lease may be for the useful life of the equipment without the lessee having an obligation to purchase the equipment. Alternatively, the lease period could be for less than the useful life of the equipment but, at the end of the lease period, the lessee has the option to purchase the equipment at a nominal price. Given their economic purposes and effects, these various types of arrangements are often called financial leases (for the definition of "financial lease", see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation).

26. Hire-purchase transactions are based on a similar principle. A typical transaction would commence with the lessee (hire-purchaser) selecting the equipment from the supplier (hire-seller) of the equipment. The lessee would then apply to a leasing company (usually a financial institution or an affiliate of one) to purchase the equipment from the supplier for cash and to lease it to the

lessee (hire-purchaser). As with an ordinary financial lease, very often the lease comprises the useful life of the equipment and, at the end of the lease period, the lessee automatically acquires ownership or has the option to purchase the equipment at the end of the lease period for a nominal sum.

27. Whether the financial lease agreement is a two-party arrangement between lessor and lessee or a three-party hire-purchase arrangement, the transaction takes the form of a lease. Nonetheless, the economic reality is that the lessee is paying the notional purchase price for the equipment in instalments, while the lessor remains the owner until full payment is made. Depending on the nature of the equipment at issue, lease periods may range from a few months to several years and items leased may range from high-value equipment, such as aircraft, to lower-value equipment, such as computers. Usually, the specific leasing arrangements are tailored to the lessee's unique cash-flow requirements, the tax regime in a State and other needs of the lessor and lessee.

(d) Seller-secured transactions

28. In many States today, a number of other legal devices are available to secure the performance of a buyer's payment obligations. As noted, some of these arise by operation of law. For example, in some States the seller of tangible property is given a high-ranking "privilege" or a "preferential claim" on the money generated by a sale in execution of the property it has sold. Whether the sale in execution is brought by the seller that has itself obtained a judgement against the buyer, by a judgement creditor of the buyer or by a secured creditor exercising a security right against the property, the seller may claim its statutory priority. What is more, this statutory preferential right is often given a rank that is superior even to that of consensual secured creditors.

29. In some States, a seller also has a right to refuse to deliver tangible property to a buyer that is not ready to pay the price at delivery. Occasionally, this right is projected forward as a reclamation right for a short period (e.g. 30 days) after delivery of the property. Neither of these rights is particularly effective as an acquisition financing right, however, since both typically presuppose that the sale is made for cash and not on credit.

30. More recently some States have also modified their law to permit a seller to take by agreement a non-possessory security right in the property sold. This type of seller's security right is usually available only in States that have also decided to permit lenders to take non-possessory security rights over tangible property. The seller's non-possessory security right is identical in form to the security right that an ordinary lender may take, but is given a special advantage. The seller that takes such a security is usually able to claim a preferred priority position that allows it to outrank any other secured creditor that is asserting rights granted by the buyer in that property.

(e) Lender acquisition financing

31. In many modern economies, lenders, rather than sellers and lessors, provide a substantial segment of the acquisition finance market. Historically, it was not possible for lenders directly to acquire any special priority rights in property for the acquisition of which they provided financing. Even where the money advanced to

the buyer was specifically intended to be used to purchase property and was in fact used for that purpose, the lender that took security in the property being acquired was considered to be a secured creditor subject to the priority rules governing security rights. That is, the lender that provided acquisition financing would rank lower than a pre-existing secured lender with a security right in a buyer's after-acquired property.

32. The only mechanism by which lenders could achieve the same preferred status as sellers and lessors was to acquire their rights. So, for example, where sellers retained ownership to secure the buyer's payment obligation, sometimes lenders would directly pay the purchase price to the seller and take an assignment of the seller's right to payment under the sale agreement, along with the seller's retention-of-title right. Similarly, in cases where the law enabled sellers to take by agreement a security right with a special priority status in the property being sold, the lender could purchase the seller's security right. Finally, in cases where the acquisition financing right arose by means of a financial lease, the lender would sometimes purchase the lease contract from the lessor. The particular form of transaction known as hire-purchase is a modern adaptation of this long-standing technique.

33. Today, however, many States permit lenders that advance credit to enable a debtor to purchase tangible property to acquire, in their own name, a preferential security right in those objects. In other words, in some States it is now possible for lenders to accede directly to a preferred status that was previously available to them only by purchasing the preferential right granted by a buyer to a seller. Nonetheless, in these States, not all lenders that provide money to a business that might ultimately be used to purchase tangible property will be able to claim an acquisition security right. The lender advancing the credit must do so to enable the purchaser to acquire the property, the credit must actually be used for that purpose and the right can only be claimed in the property thereby acquired.

34. Even though this special type of lender acquisition security right may be found in a number of States, the idea that a lender might be able directly to acquire a preferential security right in property the acquisition of which it specifically finances is not broadly accepted. Indeed, most States that permit sellers to secure the purchase price of the property they sell by means of a distinct reservation-of-title mechanism do not permit lenders to claim preferential acquisition security rights. Typically, only sellers themselves have the option of claiming such preferential acquisition security rights, which they may do as an alternative to retaining ownership.

3. Approaches to financing the acquisition of tangible property

(a) General

35. In the past, States have taken a wide variety of approaches to regulating acquisition financing transactions relating to tangible property. As noted, however, protecting the rights of sellers was typically conceived as the central objective. Moreover, until recently, in many States it was not possible to grant non-possessory security in tangible property, even to a seller. For these two reasons, the retention-of-title technique developed as an everyday practice in both civil-law and common-law systems. Sometimes States enacted legislation to acknowledge and regulate this acquisition financing technique. Most often, however, its development resulted from

changes in contractual practices relating to the sale of tangible property that were recognized and further elaborated by courts.

36. As an element of sales law that specifically touches the property aspects of the transaction, the conditions and effects of retention-of-title mechanisms vary widely from State to State. Many of these differences are products of history and the specific contractual practices that were adopted in response to the legal regime of individual States. The detailed configuration of many regimes, that is, does not result from a legislature comprehensively analysing the economic purposes served by secured transactions regimes generally or acquisition financing regimes in particular.

37. In some States, there is a real tension between the law of secured credit and existing business practices. Sometimes these business practices develop precisely to overcome existing legal rules. As such, often they are neither coherent with the legislative policy reflected by current law in a State, nor are they the kinds of practice that business would adopt if the legal regime were designed to promote efficient secured credit. Consequently, the law in this field of economic activity has frequently developed in a haphazard way. Novel contracts and additional terms to well-known types of agreement are invented in a piecemeal way as the need arises to serve as proxies for a fully developed regime to govern acquisition financing transactions.

(b) Approaches favouring seller-provided acquisition credit

38. In many States today, retention-of-title and economically equivalent devices available uniquely to sellers are the main or the only devices that provide acquisition-financing security while the buyer takes possession of the assets being purchased. Sometimes the regulation of sellers' rights is achieved by specifying a range of different legal devices within a civil or commercial code. Often, however, regulation results because particular sellers' rights are created in special statutes or by virtue of judge-made rules that deal with the various types of transactions that perform security functions whatever name they bear.

39. The approach that focuses on sellers as the principal source of acquisition finance is occasionally based on a policy decision to protect small- and medium-sized suppliers of tangible property on credit against large financing institutions. The approach acknowledges the importance of small- and medium-sized businesses (manufacturers and distributors) for the domestic economy and the dominant position of large financing institutions in credit markets. In these States, various assumptions are made to justify the policy affording special treatment for sellers that finance the acquisition of property by their buyers. One is that suppliers have an interest in providing credit at low rates to increase the volume of their sales. Another is that the cost of such credit is affordable because many suppliers do not charge interest prior to default. A third is that because there will usually be several suppliers seeking to sell property to the buyer, competitive prices will be offered to buyers.

40. A State considering secured transactions law reform needs to evaluate these assumptions carefully. While some assumptions may be justified, other assumptions may not be. For example, the fact that a supplier sells property to a buyer under a retention-of-title arrangement does not necessarily mean that the seller's credit

terms come at no cost to the buyer. The supplier itself has a cost of obtaining funds in order to extend these credit terms. In cases where interest is not charged till default, the supplier's cost of credit for itself will be embedded in the price of the property being sold.

41. Even if a State interested in promoting the manufacture and supply of tangible property wishes to encourage sellers to act as suppliers of credit, it need not do so to such an extent that other parties are excluded from offering competitive acquisition financing. In the same way that competition among sellers normally reduces prices for buyers, competition among suppliers of credit should reduce the cost of credit to borrowers. Fostering competition among all suppliers of credit will not only result in credit being available to the buyer at the most affordable rates, it is likely to open up other sources of credit enabling buyers to make payments to their sellers. In addition, making other sources of credit available to buyers will increase their capacity to purchase tangible property without the need for sellers themselves to provide financing to all their potential buyers.

42. Legal barriers that prevent financiers other than sellers and lessors from directly extending acquisition credit to buyers or that require these other financiers to extend credit only through the seller or lessor (by taking an assignment of the seller's retention-of-title claim or the lessor's lease agreement) are inefficient in other respects. Most importantly, treating acquisition financing simply as a matter of protecting the property rights of sellers and lessors can actually reduce the efficiency of the rights claimed by those sellers and lessors. Many modern secured transactions regimes offer secured creditors a number of rights that often have not, or not always, been available to sellers that deploy retention of title to secure their claims. These include, for example, automatic rights to claim security in any products that are manufactured from the property in which a security right is taken, or to claim a security right in any proceeds generated by the sale of the encumbered property, or to use the security right to secure all debts that may be owing from the buyer to the seller.

(c) Approaches promoting both seller- and lender-provided acquisition credit

43. In part to expand the range of those that may supply acquisition financing to a buyer, and in part to enable sellers to avail themselves of a full panoply of rights previously available to lenders that took regular security rights, many States today have redesigned their acquisition finance regime so as to promote both seller- and lender-based acquisition financing. Different approaches have been taken to achieve this law reform task.

44. In some States that maintain special acquisition rights for sellers based on a reservation of ownership, retention-of-title sellers are now able to expand their rights by contract through the insertion of, for example, proceeds clauses (often referred to as "extended retention-of-title" clauses) into the agreement of sale. Again, some States permit retention-of-title sellers to stipulate not only proceeds clauses, but also products clauses and all-sums clauses in order to enhance their rights. Finally, some legal systems recognize a buyer's expectancy right in property being acquired under a retention-of-title arrangement and permit the buyer to grant a lower-ranking security right in the property in favour of another creditor. Nonetheless, in most States that maintain special sellers' rights based on a reservation of ownership, only the simple retention-of-title is treated as a title

device, while these other more complex retention-of-title arrangements are either not recognized or are treated as giving rise to security rights.

45. Some States have reformed their secured transactions legislation to enable sellers to take preferential acquisition security rights, but still permit retention of title, financial leases and similar devices to co-exist as separate acquisition financing transactions. In these systems, the various devices by which ownership is deployed to secure a buyer's obligation are, however, typically regulated by substantially the same set of rules as those applicable to a seller's acquisition security rights. Still other States maintain traditional sellers' acquisition financing rights alongside sellers' acquisition security rights, but also allow lenders to claim security rights in the property being sold. To avoid the risk of imperfect coordination among various types of acquisition finance, these States often go further and integrate all acquisition financing transactions into the same framework of rules that governs security rights generally.

46. This last approach is based on a policy decision to treat, as far as possible, all transactions that are deployed to finance the acquisition of tangible objects equally. Creating equal opportunities for all credit providers, it is assumed, will enhance competition among them, thereby increasing the amount of credit available and reducing its cost. Nonetheless, States that continue to permit sellers to take security based on a reservation of ownership as well as acquisition security rights usually do not permit lenders that provide credit specifically to finance the acquisition of tangible property to accede to the preferred priority position of sellers and lessors. To do so, they must still purchase such preferred status from sellers or lessors. These types of modernized regime thus integrate sellers and lessors rights into the secured transactions regime and thereby facilitate financing on the security of the buyer's or lessor's expectancy, but do not permit these other financiers to compete directly for a first-ranking acquisition financing right in the property being purchased.

(d) Approaches based on the fully integrated “purchase-money” security right concept

47. Some States have taken a further step. Not only have they adopted an approach to acquisition financing that attempts to promote both seller and lender acquisition credit, but they have also enacted regimes that treat all providers of acquisition financing equally. In these regimes, lenders are enabled to take security in property being purchased, but also to acquire the same preferential status as sellers that take security rights in the property they sell. As a consequence, in these regimes acquisition security rights are made available equally to sellers, lessors, lenders and all other suppliers of acquisition financing. For regulatory purposes, the various acquisition financing rights of owners (retention of title, financial leases and similar devices) are (a) fully integrated into a single functional type of security right; and (b) treated identically to traditional acquisition security rights available to lenders. In many States that have adopted this approach, these various acquisition security rights are all characterized as “purchase-money” security rights.

48. Where the “purchase-money” security rights approach has been adopted two important principles govern its application. First is the idea that a purchase-money security right, which in this Guide is called an “acquisition security right”, is a generic concept. That is, it is applicable to any transaction by which a financier

provides credit to enable a buyer to purchase tangible property and takes a right in the property being purchased to secure repayment of that credit. Second is the idea that a purchase-money security right is a species of security right. That is, except where the particular circumstances of acquisition financing require a special rule applicable to such rights, all the rules applicable to security rights generally also apply to acquisition security rights.

49. The following are the key features of an “acquisition security right” (using the terminology of the Guide) in States that have adopted the fully integrated, “purchase-money” security right approach:

(a) The right is available not only to suppliers of goods, but also to other providers of credit, including lenders and lessors;

(b) The acquisition secured creditor is given, for secured transactions purposes, a security right, regardless of whether that creditor retains title to the property being acquired;

(c) The buyer may offer a lower-ranking security right in the same property to other creditors and is thus able to utilize the full value of its assets to obtain credit, thereby enhancing mobilization of capital within the economy;

(d) The acquisition secured creditor, like other secured creditors, normally has to register a notice of its security right in a general security rights registry to establish priority over competing claimants and to provide third parties with a way of being informed that another creditor claims a security right in the same property;

(e) Once a notice of the security right is registered in the general security rights registry the security right is effective against third parties;

(f) If the notice is registered within a short period of time after delivery of the property to the buyer, the acquisition security right has priority over a holder of a judgement right or an insolvency administrator of the buyer between the time of the delivery of the property to the buyer and the registration of the notice;

(g) If the property is equipment and notice is registered within a short period of time after delivery of the equipment to the buyer, the acquisition security right has priority over the security right of a pre-existing secured creditor with a security right in future equipment of the buyer;

(h) If the property is inventory and, before the inventory is delivered to the buyer, the acquisition secured creditor registers the notice in the general security rights registry and also notifies a pre-existing secured creditor with a security right in future inventory of the buyer, for which a notice has been registered in the general security rights registry, that the acquisition secured creditor is claiming a higher-ranking acquisition security right in the inventory, the acquisition security right has priority over the security right of the pre-existing secured creditor; and

(i) The acquisition secured creditor that is a seller or a lessor may enforce its rights, within or outside insolvency proceedings, in the same way as any other secured creditor and has no other title-based enforcement rights.

50. Over the past few decades, several States have adopted this fully integrated approach to acquisition security rights. This trend may also be seen at the international level. For example, the International Institute for the Unification of Private Law (Unidroit) Convention on International Interests in Mobile Equipment

governs the effectiveness against third parties of retention-of-title and financial leases with separate but substantively similar rules to those regulating security rights. Accordingly, it extends the international registry contemplated by the Convention beyond security rights to retention-of-title and to financial leasing arrangements. Moreover, under the United Nations Convention on the Assignment of Receivables in International Trade,¹ the same rules apply to (a) security assignments; (b) outright assignments for security purposes; and (c) even pure outright assignments (see art. 2, subpara. (a)), thus avoiding drawing a distinction between security rights and title devices. Indeed, article 22 of the Convention expressly covers various priority conflicts, including a conflict between an assignee of receivables and a creditor of the assignor whose retention-of-title rights in property extends to the receivables from the sale of that property (for the definition of “priority” and “competing claimant”, see art. 5, subparas. (g) and (m), of the Convention). The same approach to acquisition financing rights is followed in the European Bank for Reconstruction and Development Model Law on Secured Transactions, the Organization of American States Model Inter-American Law on Secured Transactions and the Asian Development Bank’s *Guide to Movable Registries*.

4. Key policy choices

(a) General

51. Chapter III of this Guide reviews the basic approaches to security that might be adopted by a State considering secured transactions law reform in general. A key question addressed in the chapter is how to treat transactions that fulfil the economic function of secured transactions but are effectuated by deploying title to property to secure the full payment of the financier’s claim. This question arises in both non-insolvency and insolvency contexts.

52. Many States today continue to maintain a formal diversity of financing devices in all situations. That is, they recognize both security devices and traditional devices such as mortgages and sales with a right of redemption where lenders deploy a transfer of ownership of a borrower’s property to secure performance of an obligation. Other States maintain this formal diversity in non-insolvency situations, but under their insolvency regime characterize transactions where title is deployed to secure payment of a creditor’s claim as security devices. In these States, all transactions that fulfil the economic role of security are treated as functionally equivalent for insolvency purposes.

53. Other States have adopted this “functional equivalence” approach and extended it to non-insolvency as well as insolvency contexts. The regimes in these States recognize the specificity of these various types of device and continue to permit sellers to engage in retention-of-title or resolutive sale transactions, and continue to permit lenders to engage in mortgage transactions or sale transactions with a right of redemption. However, to ensure a proper coordination among these various transactions and to ensure as far as possible their equal treatment, these States subject all these transactions, however denominated, to a framework of rules that produces functionally equivalent outcomes. Finally, some States carry this logic to its conclusion and adopt what might be called a “unitary” approach. Their secured

¹ United Nations publication, Sales No. E.04.V.14.

transactions regime characterizes as security the various transactions fulfilling the economic function of security, regardless of their form, and explicitly denominates them as “security rights” (for the definition of “security right”, see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation).

54. This Guide recommends that States adopt both a “functional equivalence” and a “unitary” approach to non-acquisition secured transactions generally. All transactions where rights in property, including ownership, are used to secure an ordinary repayment obligation by a borrower to a lender should be treated as security devices, and identified as such, in both insolvency and non-insolvency contexts (see A/CN.9/631, recommendation 11). The Guide calls this the “unitary and functional” approach. As explained in chapter III, the main advantages of the unitary and functional approach are two: (a) it more obviously promotes competition among credit providers based on price and thus is more likely to increase the availability of credit at lower cost; and (b) it better enables legislative policy decisions to be made on grounds of comparative efficiency.

55. This said, slightly different considerations arise when the obligation being secured is the payment of the purchase price of a tangible object (that is where an acquisition financing transaction is involved). The rationale for treating all lenders equally, regardless of the form of the credit transaction, does not automatically apply to situations of acquisition finance, since the parties involved are not just lenders. They are also sellers. In deciding whether to adopt the unitary and functional approach, therefore, States will have to determine (a) if the logic of secured transactions should override the logic of the law of sale and lease (or rather the logic of the law of ownership) when sellers and lessors use these transactions to secure the payment of the purchase price (or its economic equivalent) of tangible objects; or (b) if the logic of lease and sale should override the logic of secured transactions as the primary organizing principle in these cases.

(b) Functional equivalence: a generic concept of acquisition financing

56. In chapter III, this Guide notes that, while closely linked, the principles of “functional equivalence” and “unitary characterization” are independent. Equal opportunity to provide credit is the primary objective that States should seek to achieve when reforming their law of secured transactions both generally and in particular in relation to acquisition financing. The specific goals are two-fold: first, to ensure that, in so far as possible, all types of financiers are permitted to provide credit to enable business to acquire equipment and inventory; and second, to ensure that, in so far as possible, these various financiers will be subject to legal rules that treat them equally.

57. The idea of equal treatment of all financiers that provide acquisition credit is captured in the expression “functional equivalence”. There are reasons relating to both economic policy and the design of legal institutions why States might wish to adopt the functional equivalence principle. In market economies, creating equal opportunities for all credit providers will enhance competition among them, thereby increasing the amount of credit available and reducing its cost. There is no overriding reason of economic principle why the manufacturer or distributor of tangible objects should have a monopoly on providing credit to purchasers. Once it is accepted that financiers should be able to compete to offer buyers access to acquisition credit, the legal regime under which they do so should not create

incentives for one or another sub-group of financiers. The most efficient way to ensure that competition for the provision of credit is based solely on the terms and conditions offered by the financier is to establish legal rules that treat all of them in a functionally equivalent way.

58. In other words, buyers should be permitted to seek out the best deal possible to satisfy their acquisition credit needs. They should have equal opportunity to negotiate the term of the loan, the conditions of repayment, the interest charged, the events that would constitute a default and the scope of the security they provide with any potential financier. If the legal regime permits some financiers to obtain better security rights than others, this equality of opportunity to negotiate is compromised. In other words, from an economic perspective there is nothing unique about acquisition financing that would induce a State to take an approach to credit competition different from that it adopts in relation to ordinary non-acquisition financing.

59. There are also reasons relating to the design of legal institutions why a State might wish to adopt the functional equivalence principle. As noted, States have traditionally organized credit for buyers of tangible property by providing specific entitlements for sellers (the assumption being that sellers would provide most purchase-credit and most sales would be one-off transactions relating to individual items). Under such an assumption, the primary concern was simply to ensure that if the buyer did not pay the purchase price, the seller could recover the object sold quickly and efficiently and free of any third-party rights. That is, credit was simply an adjunct to the sale and the seller's primary interest was to receive value for the object provided to the buyer. Two developments required States to rethink this position.

60. First, as economies expanded, the need for acquisition credit grew and sellers found that they often could not meet all the credit needs of their buyers. Especially where manufacturers, wholesalers and retailers were purchasing large quantities of raw material and inventory, it became increasingly common for banks, finance companies and other lenders to extend credit to buyers for the express purpose of acquiring these raw materials and inventory. Second, the types of equipment needed for manufacturing and distribution became increasingly sophisticated and expensive. Moreover, often for tax reasons, buyers discovered that it was sometimes more economically advantageous to lease rather than purchase needed equipment. Frequently, these lease transactions were structured as the economic equivalent of a sale upon credit.

61. In both of these cases, a person other than the direct seller of the property provided acquisition credit to a buyer (or notional buyer). States were then confronted with having to decide whether continued reference to the seller's rights as the paradigmatic acquisition finance transaction was justifiable. The main reasons for concern lay in the fact that (a) sellers were traditionally able to get a top ranking secured right in the property sold based on their ownership, but other financiers such as lenders typically were not; and (b) when the transaction was structured as a lease rather than a sale in which the seller transferred title to the buyer against a right to have the sale set aside for non-payment of the purchase price, it was generally not possible for the lessee to deploy the leased asset as collateral to secure other credit. These concerns led States to consider whether a generic concept of an acquisition financing transaction in which the fact that credit was being offered to a

purchaser was the organizing principle might be a better way to organize this branch of secured transactions law.

62. Many States came to the conclusion that designing a legal regime in which all providers of acquisition credit would be able to exercise the same rights against a buyer-borrower in default would simplify this area of the law. That is, even when they decided that sellers should continue to be able to protect their rights by retaining ownership of the property sold until full payment by the purchaser, they concluded that the legal regime would be less uncertain and would generate less litigation if it did not draw purely formal distinctions between the rights available to different suppliers of acquisition credit. This led them to adopt the functional equivalence approach: all transactions being deployed to finance the acquisition of tangible property would be treated in essentially the same way regardless of their form and regardless of the legal status of the creditor (as seller, lessor or lender).

63. Consistent with the recommendation in chapter III (Basic approaches to security) of the Guide that States adopt the “functional equivalence” approach to non-acquisition secured transactions, in this chapter this Guide recommends that States adopt the principle of “functional equivalence” in respect of all acquisition financing transactions, however denominated (see A/CN.9/631, chapter XII, statements of purpose for unitary (sect. A) and non-unitary (sect. B) approaches; however under recommendation 174, alternative B for the non-unitary approach, there is no functional equivalence, and under recommendation 200 bis, subpara. (b), there is only qualified functional equivalence).

(c) Unitary and non-unitary approaches to functional equivalence

64. The second main policy choice that confronts States relates to the manner in which they design legislation to achieve functional equivalence. Once again, the main objective is to ensure that, in so far as possible, the legal regime that brings about this functional equivalence is crafted in a manner that facilitates the broadest extension of credit at the lowest price. This type of efficiency in a legal regime can be achieved in one of two ways. States may choose to collapse distinctions between various forms of acquisition financing transactions and adopt a single characterization of these devices. All acquisition financing transactions under the unitary approach will give rise to “acquisition security rights” and all financiers will be considered as “acquisition secured creditors” (for the definitions of “acquisition security right” and “acquisition financing right”, see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation). This Guide refers to this method as the “unitary” approach.

65. Alternatively, States may choose to retain the form of existing transactions and the characterization given to their agreement by the parties (e.g. as sale, lease or loan) subject to the court declaring that characterization a sham. In doing so, however, they will nonetheless be required to adjust and streamline their technical rules for each transaction so as to promote functional equivalence and thereby to increase efficiency. This Guide calls this method for regulating acquisition credit the “non-unitary” approach. Acquisition financing transactions under the non-unitary approach will give rise either to “acquisition financing rights” in favour of an “acquisition financier” where a title device is deployed, or to “acquisition security rights” in favour of “acquisition secured creditors” if an ordinary security right is created, whether in favour of a lender or a seller that transfers title to a buyer.

The buyer or lessee of the property where a seller or lessor claims an acquisition financing right is described in this Guide as an “acquisition financing transferee” (for the definitions of the terms mentioned in this paragraph, see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation).

66. The decision about which of these approaches to adopt is significant. It will affect the rights of third parties (both in and outside insolvency proceedings; however, the insolvency-related discussion is included in chapter XI) and, as a result, will have an impact on the availability and the cost of credit for buyers of tangible property. In addition, having decided to adopt one or the other of these approaches, States will also have to decide exactly how to design the particular rules by which all aspects of acquisition financing transactions will be governed.

67. When States adopt a unitary approach the consequences are two-fold. First, all acquisition financing devices, regardless of their form, will be considered as security devices generally subject to the same rules. This means that a creditor’s rights in property under a retention-of-title sale, sale under resolutive condition, hire-purchase agreement, financial lease, or similar transaction will be considered to be an acquisition security right and be regulated by the same rules that would govern an acquisition security right granted to a lender. Second, the buyer in such cases will be considered to have acquired ownership of the property regardless of whether the seller purports to retain title by contract.

68. States may take one of two paths to enacting the unitary approach in cases where sellers deploy a title-retention device. They may provide that the buyer becomes owner for all purposes, with the result that States would explicitly have to amend other legislation (such as taxation statutes) if they desired that sellers in such transactions would be taxed as owners. Alternatively, they might provide that buyers become owners only for the purposes of secured transactions law and its related fields (debtor-creditor law and insolvency law in particular).

69. Because this Guide adopts a unitary approach to non-acquisition financing, it contemplates the possibility of a non-unitary approach only in respect of acquisition financing transactions. Nonetheless, even when States adopt a non-unitary approach, they should design the regime to reflect the functional equivalence principle (see A/CN.9/631, recommendation 184, non-unitary approach). For example, the regime should treat, in a functionally equivalent manner, sellers that retain title, sellers that do not retain title but retain a right to cancel the sale, sellers that do not retain title but take a regular acquisition security right in the property sold, lessors that retain title, and lenders that take a regular acquisition security right in the asset sold or leased.

70. In principle, States adopting a non-unitary but functionally equivalent approach could achieve functional equivalence between the rights of sellers that retain title and financial lessors on the one hand, and the rights of acquisition secured creditors on the other, in one of two ways. They could either (a) model the rights accorded to retention-of-title and similar claimants on those given to acquisition secured creditors that are not sellers or lessors; or (b) they could model the rights of these other acquisition secured creditors on the rights already available to retention-of-title creditors. In the former case, all acquisition financiers would be treated the same (as acquisition secured creditors), but acquisition financiers that retain ownership would have slightly different rights from ordinary owners. In the

latter case, all acquisition financiers and acquisition secured creditors would be treated the same (as acquisition financiers) but acquisition secured creditors and non-acquisition secured creditors would be subject to slightly different rules. While formally these may appear to be equally viable options, in view of the overall objective to enable parties to obtain secured credit in a simple and efficient manner, there are several reasons why the former approach to achieving functional equivalence in a non-unitary regime should be preferred.

71. One may begin with the objective being sought. The question is what approach is the most likely to achieve the most transparent and lowest cost credit regardless of the source of the credit. First, it would be quite complicated to design a set of rules that would turn lenders into owners (especially since lenders normally would have no expertise in selling or maintaining the assets the acquisition of which they are financing). Second, it would be quite complicated to design a set of rules that distinguish between the rights afforded to two classes of lenders, namely ordinary secured lenders and acquisition secured lenders. Third, it is much simpler to model the rights and obligations of a seller that benefits from an acquisition financing right, i.e. an acquisition financier (for example, in relation to the creation, effectiveness against third parties, priority over competing claimants and enforcement) on those of a seller or lender that benefits from an acquisition security right (an acquisition secured creditor). The reason is that this approach would enhance the overall coherence of the secured transactions regime, while enabling States to make adjustments necessary to maintain the coherence of their regime of ownership as reflected in the law of sale and lease. It follows that States that choose to adopt a non-unitary approach to acquisition financing transactions should seek to achieve “functional equivalence” by modelling the rights of acquisition financiers on the rights of acquisition secured creditors rather than the reverse.

72. In chapter III (Basic approaches to security), this Guide recommends that States adopt the unitary approach to non-acquisition secured transactions. Given this general orientation, this Guide suggests that, to the extent that they have the opportunity to do so, States should also adopt the unitary approach to achieving functional equivalence among acquisition financing mechanisms. Notwithstanding this suggestion, however, the Guide acknowledges that some States may feel the need to retain the form of title devices in relation to sellers and other suppliers. For this reason, in each of the subsections of this chapter the relevant issues are examined as they arise in contemporary legal systems, whether they follow the non-unitary or the unitary approach. Each subsection concludes with a review of how the law of acquisition financing could be best reformed if one or the other of these approaches were adopted.

73. In section B, moreover, this chapter contains two sets of parallel recommendations. One presents recommendations about how States should design the detail of a unitary and functional approach to acquisition financing transactions (and approaches it implicitly for States that are enacting legislation to govern the full range of secured transactions for the first time). The other deals with how States that elect to retain a non-unitary approach should design rules governing acquisition financing through title devices and, in particular, “retention-of-title” and “financial-lease” transactions, as well as “acquisition security rights”, so that the economic advantages of a unitary approach may be equally achieved under a non-unitary

approach (for the definitions of these terms, see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation).

5. Creation (effectiveness as between the parties)

74. Chapter IV (Creation of a security right (effectiveness as between the parties)) of this Guide discusses the requirements for making a security right effective as between the parties. That chapter also uses the expression “creation” to characterize the requirements necessary to achieve effectiveness as between the parties. As explained in chapter IV, the underlying policy is to make the requirements for achieving effectiveness between the parties as simple as possible (see A/CN.9/631/Add.2, paras. [...]). The precise manner in which these requirements may be transposed to regulating the effectiveness of the rights flowing from an acquisition financing transaction as between the parties will depend on whether a State adopts what has been called a “unitary” or a “non-unitary” approach.

75. Moreover, in States that continue to recognize retention-of-title transactions and financial leases as distinct transactions, it is not obvious that the word “creation” is the most appropriate one to describe the rights of the seller or the lessor. For example, the lessor’s ownership rights are not created separately from the contract of lease; they are a direct consequence of the lease itself: lessors are owners. Likewise, the seller that retains ownership is not creating a new right in its favour; it is merely continuing to assert the right of ownership it had prior to concluding the agreement with the purchaser. Nonetheless, for ease of expression the agreements under which a lessor and a seller may continue to assert their ownership against a lessee or purchaser to whom they have granted possession will sometimes be described as agreements “creating” the acquisition financing rights in question (it may be argued though that, in some States, in which the buyer acquires an expectancy of ownership, a new type of bifurcated ownership is created).

76. Legal systems in States that do not treat all acquisition financing transactions in the same way impose widely varying requirements for making acquisition rights effective as between the parties. To begin, the requirements imposed may vary within each State depending on the specific acquisition financing transaction (retention-of-title, financial lease, security right) in question. In addition, they can vary widely among States even in respect of the same type of acquisition financing transaction. That is, not all States conceive retention of title and financial leases identically and, therefore, not all impose the same requirement for creating or reserving such a right.

77. As an acquisition financing right, retention of title is usually seen as a property right that arises as an adjunct to a contract of sale. That is, in many systems, the formal requirements for the creation of a retention-of-title right (for the definition of this term, see A/CN.9/631, Introduction, sect. B, Terminology and rules of interpretation) are those applicable to contracts of sale generally, with no particular additional formalities required. Hence, if a State accepts that a contract for the sale of tangible property may be concluded orally, the clause of the agreement providing that the seller retains ownership until full payment of the purchase price might also be oral. In such cases, the seller’s retention of title may be agreed to orally or by reference to correspondence between the parties, a purchase order or an invoice with printed general terms and conditions. These documents may not even bear the

signature of the buyer, but the buyer may implicitly accept the terms and conditions they set out through the taking of delivery of the property and payment of part of the purchase price as indicated, for example, in the purchase order or invoice. In other States, even though a regular contract of sale may be concluded orally, a writing (even minimal), a date certain, notarization, or even registration may be required for a retention-of-title clause in a contract of sale to be effective even as between the parties.

78. In some States, only the actual seller may benefit from a retention-of-title right and be required to follow the formalities associated therewith. Of course, credit providers that deploy financial leases, hire-purchase agreements and related transactions also retain ownership because of the nature of those contracts. The effectiveness of, for example, the lessor's right as between the parties will be dependent upon the parties complying with the ordinary formalities for third-party effectiveness applicable to the particular financial lease or hire-purchase agreement in question. Other suppliers of acquisition credit, such as lenders, may not directly obtain either a retention-of-title right or the ownership right of a financial lessor. Rather, to do so, they must receive an assignment of the outstanding balance of the purchase price from the seller or an assignment of the contract of lease from the lessor. Thus, the formalities for effectiveness of the right are, first, those applicable to the initial transaction with the purchaser or lessee, and second, those applicable to the assignment of that type of contract.

79. The various States that do not treat retention of title and financial leases as security rights also take differing approaches to the extension of these rights into other property. In some, if property subject to retention of title is commingled with other property, the retention of title is extinguished. In a few others, by contrast, the retention of title continues to be effective as between the parties without the need for the seller to undertake any further formality to preserve its right of ownership as long as similar property is found in the hands of the buyer. Similarly, in some systems, the retention of title is automatically preserved even if the property is processed into a new product, while in others retention of title cannot be extended to new products. Some States also permit lessors to continue to claim ownership of leased property that has been slightly modified, or depending on the terms of the lease, in the proceeds of an authorized disposition. In these cases as well, no additional formality to preserve effectiveness as between the parties is required.

80. There is a greater similarity in the principles governing the requirements for effectiveness of acquisition security rights as between the parties among States that have adopted a unitary approach. Indeed, almost no differences in these requirements may be found. Moreover, within each system, the formal requirements for making an acquisition security right effective as between the parties are identical regardless of whether the financing is provided by a seller, a financial lessor, a lender, or any other person. In addition, because acquisition secured credit is treated simply as a special category of secured financing (that is, because an acquisition security right is simply a species of security right), these formal requirements will be the same relatively minimal formalities as those required for non-acquisition secured transactions (e.g. a written and signed agreement identifying the parties and reasonably describing the assets sold and their price; see A/CN.9/631, recommendations 12-14). Finally, because the acquisition security right is a security

right, it will be automatically preserved in manufactured property and in proceeds of disposition (see A/CN.9/631, recommendations 18-23).

81. The difference between the two approaches and among the specific legal systems described above rarely lies in a significant way in the written form requirement. That is, most of them would accept correspondence, an invoice, a purchase order or the like with general terms and conditions, whether they are in paper or electronic form. This is, moreover, the general position concerning a writing requirement that is suggested by this Guide (see A/CN.9/631, recommendations 9 and 10). The difference seems to lie more in the requirement of a signature, which may not be necessary as long as the retention-of-title seller, acquisition secured creditor or financial lessor is able to demonstrate by other evidence that the buyer or financial lessee has accepted the terms of the agreement. Such evidence could consist merely of the buyer's or financial lessee's acquisition and use of the property without protest after having received the writing. Thus, these minimal formal requirements are not burdensome. Also, because so many transactions for the purchase of tangible property are in fact well documented for other reasons, this issue rarely arises.

82. Under the unitary approach, the requirements for effectiveness as between the parties are the same as those applicable to non-acquisition security rights (see A/CN.9/631, recommendation 184, unitary approach), and are identical regardless of the legal form (e.g. denominated security right, retention of title, title resolution, financial lease) of the transaction (see A/CN.9/631, recommendation 185, unitary approach).

83. If a non-unitary approach were adopted, States seeking to achieve the benefits of a regime that created equal competition for credit would have to develop a regime that permits lenders to acquire the preferred status that is given to acquisition financiers. They would then also have to ensure that the rules governing effectiveness as between the parties bring about functionally equivalent results regardless of the form of the acquisition financing transaction (see A/CN.9/631, recommendation 184, non-unitary approach). In particular, the rules governing (a) the capacity of parties to the contract; (b) the specific character and modalities of the obligation secured; (c) the objects upon which the acquisition financing right might be taken; (d) evidentiary obligations such as a writing and signature; and (e) the time of effectiveness of the agreement between the parties; would have to be closely coordinated so as not to favour one type of acquisition financing transaction over another (see A/CN.9/631, recommendation 185, non-unitary approach).

6. Effectiveness against third parties

(a) General

84. Chapters IV (Creation of a security right (effectiveness as between the parties)) and V (Effectiveness of a security right against third parties) of this Guide draw a distinction between effectiveness of a security right as between the grantor and the secured creditor, and effectiveness of that right as against third parties. The point has a particular salience in relation to acquisition financing rights since, depending on whether a unitary or non-unitary approach is taken, the distinction between these types of effectiveness may not actually exist.

85. Most States that do not treat retention of title as a security right, with very few exceptions, do not require retention-of-title transactions to be registered. Neither do they require the seller to take any other formal step to ensure effectiveness as against third parties. To the contrary, upon the seller and buyer concluding the agreement of sale with a retention-of-title clause, the seller's ownership right in the tangible property that has been sold is effective as against all parties.

86. By contrast, in some States registration of retention of title is required (either generally or for particular types of tangible property). In these States, it is often the case that registration is required only to make the retention of title by the seller effective as against third parties. Sometimes, however, no distinction is drawn between effectiveness of the retention of title as between the parties and its effectiveness as against third parties. That is, in some States registration of retention of title is viewed as a requirement for effectiveness even as between the parties.

87. Under any of these retention-of-title regimes, the seller that retains title has full ownership rights. As a consequence, it will usually be the case that the buyer has no rights in the property being purchased until title passes. This means that, except in those legal systems in which the buyer has an "expectancy right" to encumber, no other creditor of the buyer can claim rights in the property being purchased. This would be the case even if another creditor provided credit to the buyer to purchase the asset and the value of the buyer's assets subject to retention of title was higher than the amount of its obligations still owed to the seller. In such cases, the only property upon which the other creditor could claim security rights would be the contract of sale between the seller and the buyer. A result identical to this would also follow in the case of a financial lease. The sole property of the lessee upon which the creditor could claim security rights would be the contract of lease (assuming it were assignable).

88. Legal systems that do not recognize the right of a buyer that acquires property under a retention-of-title transaction or lessee under a financial lease to grant security over its expectancy right either prevent or make it difficult for borrowers to use the full value of either the equity they may have acquired in their tangible property subject to retention-of-title rights or the value of the financial lease contract. That is, the conceptual logic of a retention-of-title or a lease agreement disables the buyer from granting a non-possessory security right in the same assets to several creditors under a system that ranks those creditors in terms of priority for payment. Interestingly, however, in some of these same States, such a regime permitting multiple mortgagees with priority based on time of registration exists with respect to immovable property sold under a retention-of-title transaction.

89. In States that follow a unitary approach, retention of title and its economic equivalents are subject to registration of a notice in the general security rights registry (or to some other formality for making the right effective against third parties) in the same way as any other secured transaction. Under this approach, moreover, the right of the seller that retains ownership by contract or the lessor that remains owner by virtue of the nature of the lease is transformed into the right of an acquisition secured creditor. As a result, the buyer or lessee is able to use the equity it has in the property being purchased or leased as security for further credit. That is, buyers and lessees may grant security rights to other creditors in the same manner as they could were the seller to have sold the tangible property outright and simply taken its own security right in the property.

90. Under the unitary approach the requirements for third-party effectiveness are the same as those applicable to non-acquisition security rights and are identical regardless of the legal form (e.g. denominated security right, retention of title, title resolution, financial lease) of the transaction (see A/CN.9/631, recommendation 186, unitary approach).

91. If a non-unitary approach were adopted, States would have to ensure that no substantial differences in requirements for third-party effectiveness exist between the different kinds of acquisition financing transactions (see A/CN.9/631, recommendation 186, non-unitary approach). A number of rules will have to be closely coordinated so as not to favour one form of transaction over another and, in particular, the rules governing (a) the modalities by which third-party effectiveness can be achieved; (b) the timing of third-party effectiveness when requirements are met; and (c) the consequences of third-party effectiveness on the right of the buyer or lessee to grant rights in the property. Specifically, in order to maximize the buyer's or lessee's capacity to benefit from the tangible property being acquired in the non-unitary approach, States would have to provide that, regardless of the acquisition financing transaction in question, the acquisition financing transferee (for the definition of this term, see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation) has the power to grant a security right in the property subject to the acquisition financing right (see A/CN.9/631, recommendation 185 bis, non-unitary approach).

(b) Third-party effectiveness of acquisition financing transactions relating to equipment and inventory

92. As noted in chapter V (Effectiveness of a security right against third parties), the general mechanism by which ordinary security rights may be effective against third parties is through registration (see A/CN.9/631, recommendation 33). As with ordinary security rights, the registration of a notice of an acquisition financing right or an acquisition security right is meant to provide a notice to third parties that such a right might exist and to serve as a basis for establishing priority between competing claimants. Registration promotes credit market competition by providing information that enables financiers to better assess their risks.

93. For this reason, the Guide recommends that third-party effectiveness of all types of acquisition financing transaction (whether denominated as security rights, retention of title, financial leases or in some other manner) usually be dependant on the registration of a notice in the general security rights registry. Where this Guide also recommends other mechanisms to achieve third-party effectiveness for ordinary secured transactions (e.g. possession and registration in a specialized registry) these mechanisms should also be available to acquisition financiers and acquisition secured creditors as alternative means to achieve third-party effectiveness (see A.CN.9/631, recommendation 186, unitary and non-unitary approach).

94. Under the unitary approach, coordination of registration of acquisition and non-acquisition security rights in the general security rights registry will be necessary to promote certainty in the relative priority of competing claimants. Under the non-unitary approach, the rules governing the registration of a notice with respect to different title devices will also have to be coordinated with the general rules relating to the registration of a notice with respect to secured transactions. Doing so (either by adjusting the former to cohere with the latter or adjusting the

latter to cohere with the former, and by establishing a general security rights registry) will ensure certainty in the relative priority of competing claimants that hold different types of acquisition financing rights. The principles that should govern priority conflicts under both unitary and non-unitary approaches, including priority conflicts where different methods for achieving third-party effectiveness have been used (see A/CN.9/631, recommendation 193, unitary and non-unitary approach), are discussed below in the section on priority.

(c) Grace period for the registration of certain acquisition financing transactions

95. Many States seek to enhance the efficiency of the registration process by providing sellers and other financiers with a short “grace period” (e.g. 20 or 30 days) after delivery of the property sold or leased to register a notice relating to certain acquisition financing transactions. Such grace periods are found both in States that do not consider retention-of-title, financial leases and other acquisition financing rights to be security rights and in systems that consider all such rights to be acquisition security rights. The use of the grace period permits delivery of the property without waiting until registration takes place.

96. Under the unitary approach, if the notice is registered within the grace period, the acquisition secured creditor has the same priority in relation to other claimants that it would have been able to assert had it registered at or before the time of delivery. If a State were to adopt a non-unitary approach, the same rules relating to a grace period for registration and its effects should apply to all acquisition financing rights regardless of the legal form (e.g. denominated security right, retention of title, title resolution, financial lease) of the transaction. (see A/CN.9/631, recommendation 189, unitary and non-unitary approach).

(d) Exceptions to registration for consumer transactions

97. In some States where the registration of a notice relating to acquisition financing transactions would otherwise be required, an exception is made when those transactions relate to consumer goods (for the definition of this term, see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation). This means that the acquisition financing seller of tangible property bought for the buyer’s personal, household or family purposes is not burdened with a requirement to register. Such transactions become effective against third parties at the same time that they become effective as between the parties. The idea is that in such cases the need to warn potential third-party financiers is less acute (unless consumers resell those goods), especially where the consumer goods are of low value. In other legal systems that generally require registration, only relatively low-value consumer transactions are exempted from the requirement to register (e.g. consumer transactions up to a maximum of euros 3,000 or its equivalent, or transactions that are subject to the jurisdiction of small-claims courts).

98. In both types of system, the significant market involving automobile finance credit to consumers is usually served by a system requiring not registration in the secured transactions registry, but rather a notice on a title certificate. Moreover, it is important to note that in States that create an exemption from registration for consumer goods, the exception applies only to consumer transactions. In other words, the exception does not apply to a type of property, but rather only to a type of transaction relating to that property. It is still necessary to register a notice to

achieve third-party effectiveness in property normally sold to consumers if that property is being sold to a wholesaler or a retailer as inventory.

99. The exemption from registration does extend to equipment and inventory financing. Nonetheless, if a grace period were adopted for registering the notice of an acquisition financing transaction relating to equipment in the general security rights registry, that grace period may in itself serve as the equivalent of an exemption for short-term credit transactions fully paid within the grace period because, as a practical matter, the acquisition financier would not have to register before the expiry of that period. As for equipment-related acquisition financing transactions with longer repayment periods, and inventory-related transactions in general, an exemption may not be necessary if the acquisition financier could register a single notice in the secured transactions registry for a series of short-term transactions occurring over a longer period of time (e.g. five years) (see A/CN.9/631, recommendations 196 and 197, unitary and non-unitary approach).

100. Under the unitary approach, the exemption from registration for transactions relating to consumer goods would apply regardless of whether the acquisition secured creditor were a seller, lessor or lender since they would all be claiming identical rights. Were a non-unitary approach to be adopted, the rules relating to exemptions from registration for transactions relating to consumer goods should produce the same consequences regardless of the legal form (e.g. denominated security right, retention of title, title resolution, financial lease) of the acquisition financing transaction (see A/CN.9/631, recommendation 187, unitary and non-unitary approach).

7. Priority as against the rights of competing claimants

(a) General

101. This Guide adopts the term priority to deal with competitions between all persons that may have rights in property subject to a security right (for the definition of the terms “priority” and “competing claimant”, see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation). The concept of priority thus includes competitions both with (a) other creditors (secured creditors, other acquisition secured creditors, creditors that may avail themselves of a statutory preference and judgement creditors; and (b) other claimants (including prior owners, buyers and the insolvency administrator). Nevertheless, some States (and especially some States among those which do not consider retention-of-title and financial-lease rights to be acquisition security rights) adopt a more restrictive view of the notion of priority. Only competitions between creditors are considered to involve priority claims. This said, however the competition between various potential claimants is characterized, the relative rights of each must be carefully specified.

(b) Priority position of acquisition secured creditors and acquisition financiers

102. This Guide recommends in chapter IV (Creation of a security right (effectiveness between the parties)) that an ordinary security right may be taken in both present and after-acquired property (see A/CN.9/631, recommendation 12). It also recommends in chapter VII (Priority of a security right as against the rights of competing claimants) that priority generally be determined by the date of

registration of a security right, even in relation to after-acquired property (see A/CN.9/631, recommendations 78 and 79). As a result, in order to promote the provision of new credit for the acquisition of additional property, it is necessary to establish special priority rules applicable to competitions between acquisition financiers and acquisition secured creditors on the one hand, and pre-existing non-acquisition secured creditors holding rights in future assets of the grantor on the other.

103. In States that do not treat retention-of-title transactions and financial leases as security devices, the relative priority of claims is decided by reference to the seller or lessor's right of ownership. The retention-of-title seller or lessor effectively prevails with respect to the property sold over all other competing claimants (except certain bona fide buyers in an ordinary-course-of-business transaction). Moreover, in most such systems, until the buyer acquires title to the property, none of the buyer's other creditors may acquire any security rights in the property being purchased or subject to the lease. These other claimants whose rights in relation to the tangible property arise from a grant by the person acquiring it ("the acquisition financing transferee") generally cannot set up these rights against the retention-of-title seller or the financing lessor. While judgement creditors and the insolvency administrator may claim the buyer's contractual rights, unless the system permits the buyer to deal with its expectancy right, they cannot seize the property itself. For a similar reason, in cases of financial leases, neither could claim as against the actual property being leased. Finally, in most such States there can never be a competition between lenders claiming an acquisition financing right and a seller or lessor. First, it is rarely the case that the lender could acquire a right in the expectancy right of the buyer; and second, even if it could, the right would not normally be seen as an acquisition financing right. The only way in which a lender could acquire an acquisition financing right would be to purchase the rights of the seller or lessor.

104. In States that follow the unitary approach, the priority rights of a seller or a lessor that claims an acquisition financing right are equally protected. Provided that the retention-of-title seller, financial lessor or similar title claimant registers a notice in the general security rights registry within a short grace period and, in the case of inventory, takes certain other steps discussed below, they will have priority over all other claimants (except certain bona fide buyers in ordinary-course-of-business transactions). Moreover, under the unitary approach, a lender that provides financing to enable a buyer to purchase property will also be an acquisition secured creditor with priority over other claimants in the same manner as a seller or lessor. Finally, the retention-of-title seller, the financial lessor, or the seller that takes an ordinary acquisition security right, will have priority over any other acquisition financier in the same property, even if that other financier (e.g. a bank or other lender) had made its security effective against third parties before the seller did so. Thus, in States that follow the unitary approach the seller and lessor can achieve the same preferred priority position in relation to all other claimants as the retention-of-title seller or finance lessor in a non-unitary system.

105. While acquisition financing rights and acquisition security rights will normally be made effective against third parties by registration in the general security rights registry, in chapter V (Effectiveness of a security right against third parties) other methods for achieving third-party effectiveness are discussed. One of these,

possession by the secured creditor, will generally produce the same consequences as registration, and may be looked upon as an alternative to registration. As a result, should an acquisition financier or an acquisition secured creditor make its rights effective against third parties by possession within the stipulated grace period, the general priority principle would be applicable (see A/CN.9/631, recommendation 188, unitary and non-unitary approach).

106. Where the non-acquisition secured creditor makes its security right effective against third parties by registration in a specialized registry, chapter VII (Priority of a security right as against the rights of competing claimants) recommends that the registration in the specialized registry will give the registering creditor priority over even prior registrations in the general security rights registry or third-party effectiveness achieved by a prior possession (see A/CN.9/631, recommendation 83). In order to enhance the usefulness of the specialized registries, a similar rule should apply to acquisition financiers and acquisition secured creditors. They should not be able to obtain a preferred priority position simply by registration in the general security rights registry or possession within the grace period (see A/CN.9/631, recommendation 193, unitary and non-unitary approach). By implication, it would follow that, as a general principle, and subject to any superseding law, an acquisition financier or acquisition secured creditor that registered in the specialized registry would have priority over even a prior non-acquisition security right registered in that specialized registry.

107. Under the unitary approach, all acquisition secured creditors are subject to the same priority regime and must take identical steps in order to assure their priority position. The only difference between different categories of acquisition secured creditors is that in a competition between a seller or a lessor and another creditor all of whom are asserting an acquisition security right, the seller or lessor would always have priority, regardless of the respective dates of registration of their rights (see A/CN.9/631, recommendation 191, unitary approach).

108. If a non-unitary approach were adopted, to achieve functional equivalence States would likely have to make two changes to their existing regime. First, it would be necessary to permit financiers other than sellers or lessors that provide acquisition credit to acquire the preferred priority status of sellers and lessors by taking an acquisition security right. In such cases, it is important that equivalent rules relating to the priority of the seller's rights are established regardless of the legal form (e.g. denominated security right, retention of title, title resolution, financial lease) of the transaction (see A/CN.9/631, recommendation 188, non-unitary approach). Second, and concomitantly, in a competition between a retention-of-title seller, finance lessor or seller that takes an acquisition security right and an acquisition financier that is not a seller, it would be necessary to provide that priority goes to the seller or lessor, regardless of the date at which these various acquisition financing rights and acquisition security rights were registered (see A/CN.9/631, recommendation 191, non-unitary approach).

(c) Priority of acquisition security rights and acquisition financing rights as against pre-existing security rights in tangible property other than inventory or consumer goods

109. The general priority principles just noted establish a framework for organizing the rights of acquisition financiers and acquisition secured creditors, where more

than one of them may be in competition over the same tangible object. But not all tangible objects serve the same economic purpose and are subject to the same business dealings. For this reason, it is necessary to draw certain distinctions between types of such property (notably, between equipment, inventory and consumer goods). The case of equipment is especially important.

110. As noted, in most States that do not consider retention-of-title and financial leases to be security rights, the issue of competition between acquisition financiers does not arise when the acquisition financing right is a retention-of-title or a financial lease right. Pre-existing non-acquisition secured creditors are rarely permitted to acquire rights in property of which the grantor is not yet owner, and other lenders are generally not entitled to claim a special priority when they finance a buyer's acquisition of tangible objects. Moreover, even if it were possible to take a security right in the expectancy of ownership, that expectancy will only mature once the seller or lessor is fully paid. Where, however, the seller itself takes an acquisition security right rather than retaining title, and is in competition with a pre-existing non-acquisition security right, it is necessary to provide for the priority of the seller's acquisition security right.

111. In States that follow a unitary approach the protection of the acquisition secured creditor's rights will have a common basis. Upon registration, before or within a grace period after delivery of the tangible property to the grantor, the acquisition security right in the new equipment is given priority over pre-existing security rights in future equipment of the grantor. Because the acquisition security right overcomes the general rule that fixes priority based on the time of registration, this preferred position of an acquisition security right is often referred to as a "super-priority".

112. Under the unitary approach, all acquisition secured creditors of equipment are able to claim a super-priority over non-acquisition secured creditors for their acquisition security right, provided that they register a notice indicating that they are claiming such a right in the general secured rights registry within the stipulated grace period (see A/CN.9/631, recommendation 189, unitary approach).

113. States that adopt a non-unitary approach would have to provide equivalent rules relating to the priority of the seller's or lessor's rights over pre-existing rights in future equipment regardless of the legal form (e.g. denominated security right, retention of title, title reservation, financial lease) of the transaction. That is, even though the buyer is authorized to grant a security right in future equipment over which it will only have an expectancy right until the purchase price is fully paid or the financial lease concludes, and even if that security right over future equipment is made effective against third parties prior to the date of the sale, the retention-of-title seller (or similar acquisition financier) will have priority if it registers its rights within the same grace period given to any other acquisition financier (see A/CN.9/631, recommendation 189, non-unitary approach).

(d) Priority of acquisition security rights and acquisition financing rights as against pre-existing security rights in future inventory

114. Frequently, the competition between an acquisition financing right or an acquisition security right and a non-acquisition security right arises in relation to inventory. In such cases different policy considerations from those applicable to the

acquisition of equipment are at issue. The reason for this is the following. Inventory financiers typically extend credit in reliance upon a pool of existing or future inventory on a short periodic and perhaps even daily or weekly basis. The pool of inventory may be constantly changing as some inventory is sold and new inventory is manufactured or acquired. To obtain a new advance of inventory credit the grantor usually would present the lender with invoices or certifications indicating the actual status of the inventory serving as security for the new advance.

115. In States that do not treat retention-of-title transactions and financial leases as security devices, the relative priority of claims is decided by reference to the seller or lessor's right of ownership. For this reason the rights of the inventory financier are especially precarious and future advances will usually be made on the assumption that all new inventories are acquired under a retention-of-title transaction. It then becomes necessary for the creditor to determine what inventory has actually been fully paid. This has the effect of complicating a borrower's efforts to obtain future advances secured by the pool of inventory.

116. In States that follow the unitary approach the rights of the general inventory financier are more secure. Where the additional property acquired by the grantor is inventory, the acquisition security right will have priority over a non-acquisition security right in future inventory only if the registration of a notice in the general security rights registry is made prior to the delivery of the additional inventory to the grantor. In addition, in some States that follow the unitary approach, pre-existing inventory financiers that have registered their rights must be directly notified that a higher-ranking acquisition security right is being claimed in the additional inventory. The reason for this rule is that it would not be efficient to require the non-acquisition inventory financier to search the general security rights registry each time before advancing credit in reliance upon a pool of ever-changing inventory. To avoid placing an undue burden on acquisition secured creditors, however, a single, general notification to pre-existing non-acquisition inventory financiers on record may be effective for all shipments to the same buyer occurring during a significant period of time (e.g. five years or the same period that registration lasts to make a security right effective against third parties). This would mean that, once notification had been given to these pre-existing non-acquisition inventory financiers, it would not be necessary to give a new notification within the given time period for each of the multiple inventory transactions between the acquisition secured creditor and the party acquiring the inventory.

117. Under the unitary approach, acquisition secured creditors of inventory are able to claim a super-priority over non-acquisition inventory financiers for their acquisition security right provided that they register a notice indicating that they are claiming an acquisition security right in the general security rights registry and give a notice in writing to earlier registered non-acquisition financiers prior to the delivery of the inventory to the grantor (see A/CN.9/631, recommendation 192, unitary approach).

118. If a State were to adopt a non-unitary approach, equivalent rules relating to the priority of the seller's rights over pre-existing rights in future inventory should be established regardless of the legal form (e.g. denominated security right, retention of title, title reservation, financial lease) of the transaction. That is, notwithstanding that the retention-of-title seller remains the owner of the property delivered, the rules governing the sale of inventory should be adjusted so that the seller's title will

have priority over pre-existing rights in future inventory only under the same conditions as its rights would have priority were they to arise under an acquisition security right taken by that seller (see A/CN.9/631, recommendation 192, non-unitary approach).

(e) Priority of acquisition security rights and acquisition financing rights as against pre-existing security rights in consumer goods

119. This Guide recommends, by exception to the general rule, that acquisition financing rights and acquisition security rights in consumer goods be effective as against third parties without registration in the general security rights registry or creditor possession (see A/CN.9/631, recommendation 187, unitary and non-unitary approach). In other words, in relation to consumer goods the priority of an acquisition financing right or an acquisition security right over a non-acquisition security right created by the acquisition financing transferee is acquired automatically from the moment the right becomes effective as between the parties.

120. Under the unitary approach, all acquisition financiers and acquisition secured creditors of consumer goods are able to claim a super-priority over non-acquisition secured creditors for their acquisition financing right or acquisition security right without the need to make the right effective against third parties by registration or possession (see A/CN.9/631, recommendation 190, unitary approach).

121. States that adopt a non-unitary approach would have to provide equivalent rules relating to the priority of the seller's or lessor's rights over pre-existing rights in consumer goods regardless of the legal form (e.g. denominated security right, retention of title, title resolution, financial lease) of the transaction. This priority could, of course, find its source either in the seller's or lessor's ownership, or in the case of a seller or lender that takes an acquisition security right, in the general principle that applies to acquisition security rights in consumer goods (see A/CN.9/631, recommendation 190, non-unitary approach).

(f) Priority of acquisition security rights and acquisition financing rights as against the rights of judgement creditors

122. In chapter VII (Priority of a security as against the rights of competing claimants), this Guide recommends that judgement creditors that obtain a judgement and take the steps necessary to acquire rights in a judgement debtor's assets will generally have priority over existing secured creditors for advances made after they are informed of the judgement creditor's rights (see A/CN.9/631, recommendation 90). When the competing right in question is an acquisition financing right or an acquisition security right, a slightly different set of considerations, depending on the kind of tangible property at issue, must be taken into account. For example, if the tangible property is in the form of consumer goods, the acquisition financier or acquisition secured creditor is not required to register or take possession in order to make its rights effective against third parties. Hence the acquisition financier automatically benefits from a preferred priority position as against judgement creditors. If the property is inventory, the acquisition financier or acquisition secured creditor must have possession of the property, or have registered its rights and given a notice of its rights to already registered third parties prior to delivery. Hence the judgement creditor will always be on notice of the acquisition financier's or acquisition secured creditor's potential rights. In one case, however, the

acquisition financier or acquisition secured creditor is given a grace period within which to register its rights. Nonetheless, it is rarely the case that a person claiming an acquisition financing right or an acquisition security right will be making future advances.

123. This said, when a judgement creditor seeks to enforce its judgement against its debtor's property, it should not generally be able to defeat the rights of an acquisition financier or acquisition secured creditor that adds new value to the judgement debtor's estate. For this reason, if the unitary approach is adopted it should be provided that, as long as an acquisition secured creditor makes its rights effective against third parties within the grace period, it will have priority even over judgement creditors that register their judgement during that grace period (see A/CN.9/631, recommendation 194, unitary approach). If the non-unitary approach is adopted, a similar protection should be afforded to retention-of-title sellers and financial lessors and for financiers that have taken an acquisition security right (see A/CN.9/631, recommendation 194, non-unitary approach).

(g) Priority of acquisition security rights and acquisition financing rights in attachments and masses or products

124. This Guide recommends in chapter VII (Priority of a security right as against the rights of competing claimants) that a security right in an attachment to movable property that is made effective against third parties by registration in a specialized registry or by a notation on a title certificate has priority against a security right in the related property that is registered subsequently in the general security rights registry (see A/CN.9/631, recommendation 95). This recommendation rests on the fact that security rights that are effective against third parties remain effective even after the property that they encumber has become attached to other property. In such cases, if two or more security rights encumber the property at the moment of attachment, they would maintain their relative priority following attachment. In respect of a mass or product (or, in other words, commingled property), the Guide recommends that the security rights continue into the mass or product and if there are two or more, they retain their relative priority in the mass or product (see A/CN.9/631, recommendation 96).

125. In both situations, however, it is also necessary to determine the relative priority of rights taken in the different tangible property that is united by attachment or commingled. The Guide provides that the regular priority rules apply so that the date of registration in the general security rights registry would determine priority, unless one of the security rights was an acquisition security right. An acquisition security right taken in a part of commingled property would have priority over an earlier registered non-acquisition security right (and presumably even an acquisition security right) granted by the same grantor in the whole mass or product (see A/CN.9/631, recommendation 98). This Guide does not, however, take a position on whether an acquisition security right in an attachment should have priority over an earlier registered non-acquisition (or even acquisition) security right granted by the same grantor in the tangible property to which the attachment is attached.

126. In States that do not consider retention of title and financial leases as security devices, the general priority rules set out in chapter VII would not directly apply to acquisition financing. Chapter VII deals with situations where all forms of secured

transaction are treated as security rights under the general unitary and functional approach. In the acquisition financing context, however, the relative rights of the parties depends on general rules governing attachments. Normally, if the attached property can be detached without damaging the property to which it is attached, the retention-of-title seller would retain its ownership in the attachment. If the attachment could not be so removed, it is necessary to determine whether the attachment or the property to which it is attached is the more valuable. If the tangible property in which a seller has retained ownership is more valuable, the retention-of-title seller acquires ownership of the whole, subject only to an obligation to pay the value of the other property. If the tangible property in which a seller has retained ownership is less valuable, the retention-of-title seller loses its ownership and merely has a claim against the new owner for the value of its former property.

127. Under the unitary approach, acquisition secured creditors with rights in attachments and property that is commingled are generally able to claim a super-priority over non-acquisition inventory financiers. They will have priority over other secured creditors claiming a right in the attachment or in the tangible property that is being commingled or processed. They will also have priority over non-acquisition secured creditors of the property to which the attachment is attached, at least in so far as the value of the attachment is concerned, and they will have priority over non-acquisition secured creditors with security over the entire mass or product (see A/CN.9/631, recommendations 96-98).

128. If a State were to adopt a non-unitary approach, equivalent rules relating to the priority of the seller's rights over other rights in the attachment or the tangible movable property to be commingled or processed should be established regardless of the legal form (e.g. denominated security right, retention of title, title resolution, financial lease) of the transaction. That is, notwithstanding that the retention-of-title seller of an attachment might lose its ownership upon attachment, the seller should be able to claim its priority either in the share of the mass or product that it sold, or upon the attachment that it sold. The exact mechanism by which the rules of attachments to movable property would have to be adjusted depends on the detail of the law in each particular State that chooses to adopt the non-unitary approach.

(h) Priority of acquisition security rights and acquisition financing rights in attachments to immovable property

129. In chapter VII (Priority of a security right as against the rights of competing claimants), this Guide recommends that, after attachment, a security right in attachments to immovable property that is made effective against third parties under immovable property law has priority over a security right in those attachments made effective against third parties under the law relating to secured transactions. Conversely, if the security right in tangible property is made effective against third parties before attachment and is registered in the immovable registry it will have priority over subsequently registered security rights in the immovable property (see A/CN.9/631, recommendations 93 and 94). The logic of these provisions should also apply to acquisition financing rights and acquisition security rights.

130. The rights of an acquisition financier or acquisition secured creditor in tangible property that will become an attachment should have priority over existing encumbrances on the immovable property provided that it is registered in the

immovable registry within a reasonable period after attachment. In this case, the person claiming an existing encumbrance on the immovable property made its advances on the basis of the value of the immovable property at the time of the advances and has no pre-existing expectation that the attachment would be available to satisfy its claim. Of course, in cases where the pre-existing encumbrance on the immovable property secures a loan that is intended to finance construction, this same assumption would not hold, and the rationale for preserving the acquisition financier's or acquisition secured creditor's preferred priority is less compelling.

131. Under the unitary approach, a single rule governing these cases is possible since the claim of the acquisition secured creditor will always be a security right (see A/CN.9/631, recommendation 195, unitary approach). Should a State adopt the non-unitary approach, however, it will be necessary to adjust the rules relating to attachments to achieve a result that is functionally equivalent regardless of the form of the transaction. That is, it would be necessary to specify that the retention-of-title seller and the financial lessee will lose their priority to a construction financier even when the title to the property being attached does not automatically pass to the owner of the immovable property (as would be the case for property sold under retention of title or leased under a financial lease that is fully incorporated into the immovable property) (see A/CN.9/631, recommendation 195, non-unitary approach).

(i) Priority as between competing acquisition security rights and acquisition financing rights

132. In the various priority conflicts already described in this section, the competing claimants are asserting different rights in tangible property. That is, the conflicts are between the rights of an acquisition financier or acquisition secured creditor and a non-acquisition secured creditor, a judgement creditor or a creditor with security in immovable property asserting rights in an attachment. It may be, however, that the competition is between two claimants, each of whom is asserting rights arising from an acquisition financing transaction. There are various situations in which this may occur and the policy considerations that should bear on the resolution of such conflicts are complex.

133. In States that do not treat retention-of-title transactions and financial leases as security devices, the relative priority of claims is decided by reference to the seller's or lessor's right of ownership. Unless that system permits other creditors to take a security right in the expectancy right of the buyer, a competition between owners and secured creditors would not arise. Further, even if it were possible for a creditor to take a security right in a buyer's or lessee's expectancy right, that expectancy right will only mature once the seller or lessor is fully paid. In other words, in most such systems, there can never be a competition between lenders claiming rights under an acquisition financing transaction and a seller or lessor. The only way that a lender could acquire an acquisition financing right would be to obtain an assignment of the secured obligation from the retention-of-title seller or the financial lessor.

134. Furthermore, in States that do not treat retention-of-title transactions and financial leases as security devices, it is often possible for a seller (although not a lessor) to transfer title of the property being sold to the buyer and to take back a security right. Sometimes these seller's rights arise by operation of law (e.g. the vendor's privilege) but sometimes they also arise as a result of a security agreement

between the seller and the buyer. In such cases, the buyer may well grant competing security rights in the property being acquired. These rights might be security rights granted and registered after the property has been purchased or beforehand, by virtue of a security right covering present and future property. Nonetheless, even when the lender advances credit to enable the buyer to acquire the property, the security it takes in the property being acquired is invariably considered to be an ordinary security right. That is, in most States that do not treat retention-of-title transactions or financial leases as security devices it is not possible for lenders to directly accede to the preferred priority position that is given to a seller that takes an acquisition security right. This would be the case even where the buyer would obtain ownership from the seller and would grant the seller an acquisition security right in the property being purchased. Once again, in most such States, the only way that a lender could acquire the preferred priority afforded to an acquisition security right would be to obtain an assignment of the secured obligation from the seller that has taken such a security right for itself.

135. In States that follow the unitary approach, the priority rights of a seller and a lessor are protected because the rights they would otherwise claim are characterized as acquisition security rights and are given the same preferred priority position through the concepts of the “purchase-money security interest” super-priority. Such a preferred priority position is also afforded to sellers that simply take a security right in the property being supplied. In addition, and by exception to the situation that prevails in non-unitary systems, it is possible for lenders that advance money to borrowers so as to enable them to purchase tangible property to take a security right in the property being acquired that will be characterized as an acquisition security right. In other words, under the unitary approach, it is possible to have a genuine conflict between more than one acquisition security right.

136. Under the unitary approach followed in many jurisdictions, the law explicitly provides that in any competition between a seller that is claiming an acquisition security right and a lender that is also claiming an acquisition security right, the seller’s acquisition security right will have priority regardless of the respective dates that these acquisition security rights were made effective against third parties. These unitary systems also provide that in a competition between two acquisition security rights taken by lenders, the date at which the right became effective against third parties will determine the relative priority of the two rights.

137. The policy decision that must be taken in States that choose to adopt a non-unitary approach is whether to permit financiers other than sellers or lessors to take security rights in property being acquired by their borrower that can achieve the preferred priority status of an acquisition security right. If not, there will never be a competition between two or more acquisition security rights or between an acquisition financing right and an acquisition security right. If so, States will also have to adopt a rule that provides for the priority of an acquisition financing right taken by a seller or a lessor or an acquisition security right taken by a seller over any other acquisition financing right or acquisition security right, whatever the respective date on which the seller’s or lessor’s rights became effective against third parties. Moreover, States will also be required to specify that, as between acquisition financing rights and acquisition security taken by financiers other than sellers or lessors, the priority of these rights will be determined by the date they

became effective against third parties, regardless of the form of the transaction (see A/CN.9/631, recommendation 191, unitary and non-unitary approach).

138. There are several reasons why States that select a non-unitary approach might wish to permit lenders to accede to the status of acquisition secured creditors directly (that is, without having to take an assignment of a seller's or lessor's ownership rights, or a seller's own acquisition security right). First, consistent with the overall objectives of this Guide, once it is accepted that a buyer may grant security in its expectancy right, there is no reason of principle to restrict this possibility to the grant of ordinary security. Second, and again consistent with the overall objectives of this Guide, permitting lender-provided acquisition financing credit will enhance competition for acquisition financing credit as between sellers and lessors and lenders (which should have a beneficial impact on the availability and the cost of credit). Third, without the possibility of lender-provided acquisition financing credit, lenders that wish to advance credit to their debtors-buyers against the expectancy right in property being acquired, will not have a preferred priority position as against other secured creditors on that expectancy right. They will simply rank according to the date their security became effective against third parties. That is, a later-in-time lender that wishes to advance credit specifically to enable a debtor to acquire tangible property will (in the absence of a subordination agreement) always rank after a general financier that has previously made its security effective against third parties.

(j) Multiple acquisition financing transactions

139. In many situations, a seller or other acquisition financier, or an acquisition secured creditor, will offer to provide financing to permit the acquisition of several assets. This could involve, for example, multiple sales with multiple deliveries of inventory, or multiple sales of several pieces of equipment. In these situations, it is necessary to decide, as a matter of policy, whether the acquisition financier or acquisition secured creditor benefits from its special priority rights over all equipment or inventory financed by it, without the need to identify the purchase price due under each particular sale. If so, the legal system in question is said to permit "cross-collateralization".

140. In States that do not treat retention-of-title transactions and financial leases as security devices, the issue of cross-collateralization usually does not arise. In the normal case of a retention-of-title or similar title transaction, the contract of sale or lease applies only to the specific assets sold or leased under that contract. Thus, while the same agreement may cover multiple deliveries, it would not cover multiple sales. The priority claim of the seller or lessee would relate to the specifics of each sale or lease. Some of these States do, however, permit the retention-of-title right to be extended by providing, for example, that the parties may agree to an "all monies" or "current account" clause where inventory is being sold. Where such clauses are used, the seller retains ownership of the property sold until all debts owing from the buyer to the seller have been discharged and not just those arising from the particular contract of sale in question (in some States though, retention-of-title sales with "all monies" or "current account" clauses are often characterized by courts as security devices).

141. In States that follow the unitary approach, the usual rule is that the super-priority of acquisition security rights, at least in inventory, is not impaired by cross-

collateralization. This means that the acquisition secured creditor may claim its preferred priority position in relation to inventory for the acquisition of which it has provided the financing without being obliged to specifically link any outstanding indebtedness to any particular sale or lease transaction. Of course, in such cases, the special priority right does not extend to other property, the acquisition of which was not financed by that acquisition secured creditor.

142. Under the unitary approach, the goal is to permit a maximum of flexibility to acquisition secured creditors that provide financing for the acquisition of inventory, and to minimize the transactional paperwork associated with multiple acquisition transactions involving the same acquisition secured creditor. The rule permitting cross-collateralization achieves this result (see A/CN.9/631, recommendations 196 and 197, unitary approach). Under a non-unitary approach, because a contract of sale or lease normally applies only to the specific assets sold, it would be necessary to modify the rules relating to retention-of-title sales and finance leases so as to permit cross-collateralization. Moreover, should a seller under the non-unitary approach or any acquisition secured creditor that is not a seller take an acquisition security right in the property sold, the seller or other financier should be enabled to exercise a right of cross-collateralization in the same manner as under the unitary regime (see A/CN.9/631, recommendations 196 and 197, non-unitary approach).

(k) Acquisition financing priority in proceeds of tangible property other than inventory or consumer goods

143. In many cases, the acquisition financier or acquisition secured creditor knows that the buyer will resell the property being acquired. This is obviously the case with inventory, but sometimes a manufacturer or other business enterprise will sell existing equipment in order to acquire upgraded equipment. As discussed in chapter IV (Creation of a security right (effectiveness as between the parties)), an ordinary security right in tangible property will normally extend into the proceeds of its disposition (see A/CN.9/631, recommendation 18). This extension of a security right into proceeds raises the policy question of whether the special acquisition finance priority should also extend to proceeds, and whether the rules for making such a claim should be the same regardless of whether equipment or inventory is being purchased.

144. In States that do not treat retention-of-title transactions and financial leases as security devices, the issue of a seller or lessor claiming special rights in proceeds generated by the sale of equipment often generally does not arise (see below for exceptions). This is because the law of sale or lease limits the seller's retained ownership right or the lessor's ownership only to the property sold or leased, and in the case of a sale only so long as this property remains in its original condition (i.e. unaltered by a manufacturing process or by customization). Of course, in cases of unauthorized disposition, the seller or lessor may be able to recover the property in kind from the person to whom it has been transferred. But sometimes the property cannot be found, although property or money received for its disposition can be identified. In addition, sometimes the seller or lessor permits the sale on condition that the seller's or lessor's title is extended to the proceeds and the products of the property in which the seller or lessor retained title. In these two situations, some States do permit the seller or lessor to claim ownership by real subrogation into the proceeds and products of the property sold under retention-of-title or leased. Where

the contract is a sale, it is common to speak of the seller's rights as an "extended retention of title".

145. In some States that follow the unitary approach, the super-priority of an acquisition security right extends only to the property the acquisition of which is financed, while in other States it may extend to its identifiable proceeds and products as well, at least in the case of transactions relating to equipment. Since the grantor does not usually acquire equipment with a view to immediate resale, there is little concern about prejudicing other secured creditors if the super-priority of an acquisition security right in equipment is extended to the proceeds of its disposition. If the equipment becomes obsolete or is no longer needed by the grantor, and is later sold or otherwise disposed of by the grantor, the secured creditor will often be approached by the grantor for a release of the security right to enable the grantor to dispose of the equipment free of the security right. Absent that release, the disposition would be subject to the security right and it would be unlikely that a buyer or other transferee would pay full value to acquire the equipment. In exchange for the release, the secured creditor will typically control the payment of the proceeds, for example by requiring that the proceeds of the disposition be paid directly to the secured creditor for application to the secured obligations. Under these circumstances, it is unlikely that another creditor would rely upon a security right taken directly in an asset of the grantor that is proceeds of the disposition of the equipment initially subject to an acquisition security right.

146. Under the unitary approach, the assumption is that the equipment is not normally subject to ongoing turnover. The acquisition secured creditor's control over the disposition of the asset supports the conclusion that the special priority afforded to acquisition secured creditors should be extended into proceeds of disposition and products of the property covered by the acquisition security right (see A/CN.9/631, recommendation 198, unitary approach).

147. If a State adopts a non-unitary approach, the rules relating to the maintenance of a special priority in proceeds of equipment should produce the same consequences as against other claimants regardless of the legal form (e.g. denominated security right, retention of title, title resolution, financial lease) of the acquisition financing transaction. That is, the special priority of the retention-of-title seller or lessor of equipment should be claimable in the proceeds of disposition, either by continuing the seller's or lessor's title in the proceeds or by giving the seller or lessor the same priority claim as a seller that took an acquisition security right (see A/CN.9/631, recommendation 198, non-unitary approach).

(I) Acquisition financing priority in proceeds of inventory

148. The situation in relation to proceeds of inventory is different from that relating to proceeds of equipment for three reasons (each reason is equally applicable whether a non-unitary or unitary approach is adopted). First, inventory is expected to be sold in the ordinary course of business. Second, the proceeds of the sale of inventory will predominantly consist of receivables rather than some combination of a trade-in and receivables. That is, to take an example, it would not normally be the case that a seller of clothing or furniture would take back the purchaser's used clothing or furniture in partial payment of the purchase price. Third, it will often be the case that a pre-existing secured creditor, in extending working-capital credit to the grantor, will be advancing credit to the grantor on a periodic or even daily basis

in reliance upon its superior security right in an ever-changing pool of existing and future receivables as original encumbered assets. It may not be possible or practical for the grantor to segregate the receivables that are the proceeds of the inventory subject to an acquisition financing right or an acquisition security right from other receivables over which a pre-existing creditor has taken a security right. Even if it were possible or practical for the grantor to segregate the proceeds generated by the disposition of inventory over which an acquisition financing right or an acquisition security right had been granted, it would have to do so in a way that was transparent to both financiers and that minimized monitoring by both financiers.

149. Without such a prompt segregation that is transparent to both financiers and that minimizes monitoring, there is a significant risk that the pre-existing secured creditor extending credit against receivables would mistakenly assume that it had a higher-ranking security right in all of the grantor's receivables. There is likewise a risk of a dispute between the pre-existing secured creditor and the retention-of-title seller, purchase-money lender or financial lessor as to which financier has a priority right in which proceeds. All of those risks and any concomitant monitoring costs may result in the withholding of credit or charging for the credit at a higher cost. Of course, if the priority of the acquisition financing right or acquisition security right in the inventory does not extend to the receivables proceeds, the inventory acquisition financing creditor or acquisition secured creditor may itself withhold credit or offer credit only at a higher cost.

150. However, that risk may be ameliorated in a significant respect. For example, if the priority of the acquisition financing right or acquisition security right in the inventory does not extend to the receivables proceeds, a pre-existing secured creditor with a prior security right in future receivables of the grantor will be more likely to extend credit to the grantor in reliance upon its higher-ranking security right in the receivables to enable the grantor to pay for the inventory acquired by the grantor. The amount of the advance by the pre-existing secured creditor should be sufficient for the grantor to pay the purchase price to the seller of the inventory. This is because usually advance rates against receivables are much higher than those against inventory and because the amount of the receivables reflects a resale price for the purchase of the inventory well in excess of the cost of the inventory to the seller. Thus, there is a greater likelihood that the purchase price will be paid on a timely basis.

151. Under the unitary approach, the complexity of determining what receivables arise from the disposition of property over which an acquisition security right exists, and the widespread use of receivables as original property subject to a separate security right, are cogent reasons why the special priority afforded to acquisition security rights in inventory should be limited to proceeds of disposition other than receivables and other payment rights (see A/CN.9/631, recommendation 199, unitary approach).

152. Should a State adopt a non-unitary approach, the special priority given to acquisition financiers and acquisition secured creditors should not be extended to proceeds of disposition in the form of receivables and other payment rights regardless of the legal form (e.g. denominated security right, retention of title, title resolution, financial lease) of the acquisition financing transaction. In particular, the special priority of the retention-of-title seller of inventory should be claimable by means of a real subrogation only into other tangible property, and not into proceeds

of disposition of that inventory that take the form of receivables and other payment rights (see A/CN.9/631, recommendation 199, non-unitary approach).

8. Pre-default rights and obligations of the parties

153. As noted in chapter VIII (Rights and obligations of the parties), in most States there are very few mandatory rules setting out pre-default rights and obligations of the parties. The vast majority of applicable rules and principles are suppletive (non-mandatory) and may be freely derogated from by the parties. In addition, for the most part the pre-default rights and obligations of the parties will depend on how any particular State conceives the legal nature of the transaction by which an acquisition financing right or acquisition security right arises. In particular, the way in which these rights and obligations are cast will largely depend on whether the State in question adopts a unitary or a non-unitary approach to acquisition financing transactions.

154. In States that do not treat retention-of-title transactions and financial leases as security devices, the regime governing pre-default rights and obligations applicable to non-acquisition security rights cannot be simply transposed to acquisition financing rights. Of course, the rules applicable to non-acquisition security rights (whether taken by a seller or by a lender) can mirror those applicable to acquisition security rights. But where a title device (retention of title, financial lease or similar transaction) is at issue, it will be necessary to adjust the manner by which these rules are expressed.

155. Because the objective is to achieve functional equivalence among all acquisition financing transactions, this will often require reversing the default presumptions about the prerogatives of ownership. That is, normally it is the owner (the retention-of-title seller or the financial lessor) that has the right to use, and collect, the civil and natural fruits produced by an object. Normally it is the owner that bears the risk of loss and, therefore, has the primary obligation to care for the property, maintain it, keep it good repair and insure it. And normally, it is the owner that has the right to further encumber the object and to dispose of it. To achieve the desired functionally equivalent results, therefore, States will have to provide a mix of mandatory and non-mandatory rules vesting each of these prerogatives and these obligations in the buyer and not in the seller or lessor.

156. States that adopt the unitary approach need not attend directly to this issue since an acquisition security right is simply a species of security right. As such, it would only be necessary to apply the regular rules about pre-default rights and obligations to all acquisition financing transactions, regardless of the form of the transaction in question. That is, there is no reason to assume that obligations relating to use, the obligation to protect the value of the secured property, the collection of civil and natural fruits, the right to encumber, or the right to dispose should be any different simply because the security right at issue is an acquisition security right. If acquisition secured creditors and grantors wish to provide for a different allocation of rights and obligations, they should be permitted to do so within exactly the same framework as applicable to non-acquisition secured rights (see A/CN.9/631, recommendations 108 and 109).

157. Should a State adopt the non-unitary approach, the specific pre-default rights and obligations of the parties will have to be spelled out in greater detail in order to

achieve functional equivalence. These rules will often have to be enacted as exceptions to the regular regime of property rights applicable to owners. Of course, as noted, most of the pre-default rules will not be mandatory. However, since the non-mandatory default regime should establish a set of terms about pre-default rights and obligations that the legislature believes the parties would choose to most efficiently achieve the purpose of a security device, States that do adopt the non-unitary approach should ensure the enactment of non-mandatory rules that mirror those it enacts to govern acquisition security rights taken by sellers or lenders. So doing would have the additional advantage of clearly specifying the right of the buyer to grant security over its expectancy right, and confirming the buyer's right to use, transform or process the property in a reasonable manner consistent with its nature and purpose (see A/CN.9/631, recommendations 108 and 109).

9. Post-default rights of the parties

158. The discussion in chapter X (Post-default rights) illustrates that in most legal systems the rules relating to enforcement of post-default rights flow directly from the manner in which that legal system characterizes the substantive right in question. For example, many systems consider certain rights to be "property rights" and provide for special remedies to ensure their effective enforcement. Other rights are characterized as "personal rights" and are usually enforced by bringing an ordinary legal action against a person. In such systems, both the right of ownership and security rights in tangible property are seen as a species of "property right" enforceable through an *in rem* action (an "action against the property"). Although the specifics of enforcement of property rights through property actions can vary greatly depending on the particular property right enforced and the specific configuration of a State's procedural laws, for the most part these rules governing enforcement of post-default rights are mandatory. As such, they cannot be derogated from the parties to an acquisition financing right or an acquisition security right.

159. In States that do not treat retention-of-title transactions and financial leases as security devices, the procedure for enforcement of the seller's or the lessor's rights will normally be that open to any person that claims ownership in tangible property. So, for example, upon default by the buyer, the retention-of-title seller may terminate the sale agreement and demand return of the property as an owner. In that event, and subject to any term of the agreement to the contrary, the seller is normally also required to refund at least a part of the price paid by the buyer. This amount of the payment due by the seller is often calculated by requiring disgorgement of all money received from the buyer, minus the rental value of the property while in the possession of the buyer and the amount by which the value of property has decreased as a result of its use by the buyer, or damages determined under a similar formula.

160. In these States, a seller that terminates the sale is usually not obliged to account to the buyer for any of the profits made on any subsequent resale of the property but, at the same time, unless otherwise provided by contract, the seller has no claim against the buyer for any deficiency beyond any damages resulting from the buyer's breach of the original sales contract. In some legal systems, courts have also ruled in certain instances that there is an implied term in retention-of-title arrangements that the seller cannot repossess more of the property sold than is necessary to repay the outstanding balance of the purchase price. Finally, in most of

these legal systems, neither the defaulting buyer nor any third party, such as a judgement creditor or a creditor that has taken security on the expectancy right of the buyer in the property being reclaimed by the seller, may require the seller to abandon its right to recover the property. Because the seller is the owner of the property being reclaimed, it cannot be compelled to sell that property as if it were simply an acquisition secured creditor enforcing an acquisition security right.

161. The position of a seller that reclaims ownership and possession of property under a proviso that, having transferred ownership to the buyer, it may retroactively set aside the sale should the buyer not pay the purchase price as agreed (a resolutive condition) is similar to that of the retention-of-title seller. Upon default, the sale is terminated and the seller reacquires ownership, and may reclaim possession of the property as the owner. That is, once the resolutive condition takes effect, the rights and obligations of the seller that regains ownership are identical to those of the retention-of-title seller.

162. The situation of the financial lessor is normally slightly different. Since the form of the lease is such as to be a contract of continuing performance (the lessee has continuing possession and use while the lessor has a right to payment), under most legal systems, the lease contract will be terminated for the future only. This result means that the lessee will lose the right to purchase the property at the end of the lease (or to automatically acquire ownership if the contract so provides), and that the lessor will keep the full rental payments received. Subject to any contrary provision in the lease agreement, however, the financial lessor will not be able to claim for the normal depreciation of the property. Damages will be claimable only for waste or extraordinary depreciation. Moreover, financial lessors will not usually be able to claim for the difference between the amount they receive as lease payments and the depreciation of the leased property.

163. Under the unitary approach, the acquisition secured creditor may repossess the property, as would any other secured creditor. Whether the acquisition secured creditor is a seller, lessor or lender, it will be able, as outlined in chapter X (Post-default rights), either to sell the property, or if the grantor or other secured creditor do not object, to take the property in satisfaction of the secured obligation. In the former case, the enforcing creditor will be able to sell under judicial process or privately. Having sold the property, the secured creditor then has to return to the grantor any surplus on the resale of the property, but concomitantly has an unsecured claim for any deficiency after the sale (see A/CN.9/631, recommendation 200, unitary approach).

164. If a State adopts the non-unitary approach, several adjustments to existing rules relating to the enforcement of the ownership right of a retention-of-title seller or a financial lessor would have to be made in order to achieve equality of treatment among all acquisition financiers and between these acquisition financiers and acquisition secured creditors. These adjustments would include, for example, giving the buyer or lessee and any secured creditor with a right in the buyer's or lessor's expectancy right, the right to compel a seller or lessor to sell the property in which ostensibly it has a right of ownership, rather than simply assert that ownership right to regain possession of and ultimately to dispose of the property. That is, an acquisition secured creditor may propose to take the property in satisfaction of the buyer's outstanding obligation, but the buyer or other interested party may compel the acquisition secured creditor to sell the property instead. Achieving functional

equivalence would mean that buyers and other interested parties would be enabled to compel the retention-of-title seller (an owner) to abandon the assertion of its right of ownership and to sell the property as if it were simply an acquisition secured creditor. It would also require adjusting the seller's or lessor's rights so that they would be required to account for a surplus upon any sale in disposition, while at the same time permitting them to recover as simple contractual claimants for a deficiency without having to bring a separate action in damages.

165. Of course, deficiencies are much more common than surpluses. Still, requiring an acquisition financier to account to the buyer and other creditors with security in the expectation right of the buyer for any surplus upon enforcement will encourage those other creditors to monitor the enforcement process closely and thereby enhance the chances that the highest possible value will be achieved. Likewise, providing the creditor with a deficiency claim allows the creditor to enforce its full claim, which enhances the likelihood of complete repayment. A rule that would deny, absent a contractual term for damages, a deficiency claim to an acquisition financier (whether by retention of title or financial lease), when such a deficiency claim would be enforceable by a seller or lender that exercised an acquisition security right, would be unfair and inefficient. The rights of a seller, especially, should not be significantly different (either to the seller's advantage or to its disadvantage), depending only on whether it chose to retain title or to take an acquisition security right.

166. Arguably, either remedial scheme might be appropriate for a State to consider so long as the enforcement regime applied equally to retention-of-title sellers, financial lessors and acquisition secured creditors. In other words, as a matter of strict legal logic, it is possible to achieve functionally equivalent enforcement results regardless of whether a unitary or a non-unitary approach is adopted. The need for these several adjustments to existing retention-of-title and financial-lease regimes in order to achieve the full benefit of treating all sources of acquisition financing equally, as recommended in this Guide (see A/CN.9/631, recommendation 184, non-unitary approach), suggests that it may be preferable for States that have not already achieved this coordinated result through legislative, judicial or contractual adjustments to their rules governing retention-of-title transactions and financial leases to do so by adopting the unitary approach. Nonetheless, the non-unitary approach will, if implemented as recommended in this Guide (see A/CN.9/631, recommendations 200-200 *très*, non-unitary approach), produce an efficient enforcement regime for acquisition financing transactions.²

10. Private international law

167. Many legal systems differentiate between rights of ownership and security rights in presenting rules relating to the applicable law. Under the unitary approach, whether an acquisition financing transaction involves a purported retention of title, a financial lease or an ordinary security right is immaterial. All will be considered as security rights and dealt with accordingly (see chapter XIII, Private international law).

² The discussion of the treatment of acquisition security rights and acquisition financing rights in the case of insolvency is included in chapter XI (Insolvency) of this Guide, so as to ensure that all insolvency-related issues are contained in the same chapter.

168. Should a State decide to retain a non-unitary approach, however, it will face the question of whether the private international law rules applicable to the creation, third-party effectiveness, priority and enforcement of retention-of-title, financial leases and similar arrangements should be the same as those that apply to acquisition security rights or, more generally, to ordinary security rights that are taken in the same type of assets. The goal of achieving functional equivalence is a strong argument that States should characterize the ownership rights of acquisition financiers as acquisition security rights for private international law purposes (see chapter XIII, Private international law).

11. Transition

169. The rules regarding the treatment of what were previously non-security devices represent a significant change for most legal systems. In particular, the characterization of retention-of-title and financial leases (including hire-purchase agreements) as acquisition security rights will bring about an important modification to the scope of secured transactions law in legal systems that have not already adopted the unitary and functional approach to secured transactions generally. Chapter XIV (Transition) of the Guide discusses principles that should govern the transition to a new regime. In principle, the same principles should govern the transition in relation to acquisition financing rights and acquisition security rights as apply to the transition in relation to non-acquisition security rights.

170. With respect to retention-of-title devices and financial leases, a smooth transition depends on attending to the detail of the previous regime. If it were already obligatory for retention-of-title creditors and financial lessors to register their rights, then it would only be necessary to provide for a certain delay within which the registration would have to be renewed in the new general security rights registry. Alternatively, the law could provide that the existing registration would remain effective for a sufficiently long time (e.g. three to five years) to cover the life span of most retention-of-title or financial lease arrangements (see A/CN.9/631, recommendation 226).

171. If no registration is currently necessary, a smooth transition could be achieved if, consistent with the transition rules applicable to non-acquisition financing transactions, the effectiveness of the rights of retention-of-title sellers and finance lessors against third parties and their priority position are preserved by registering an appropriate notice in the security rights registry. Alternatively, the law could provide that the registration requirement would take effect at a date sufficiently far in the future after the new law comes into force (e.g. three to five years) that it would cover the life span of most retention-of-title arrangements existing at the time of the enactment of the law (see A/CN.9/631, recommendation 226).

172. Even should a State decide to adopt a non-unitary approach to acquisition financing transactions and to maintain retention-of-title and financial lease regimes, in order to establish an efficient secured transactions law, it will be necessary to reorder a number of rules relating to these transactions. Since the Guide recommends that they be registered in the general security rights registry, the same transition rules for registration applicable to the unitary approach could be adapted for the non-unitary approach. As for the substance of the law, similar adjustments would be necessary in order to produce outcomes that are functionally equivalent to

those achieved under a unitary approach. In particular, it would be necessary to determine when the rules relating to the following issues will come into effect: (a) the priority of acquisition financing rights in proceeds; (b) the rights of third parties to acquire security rights in assets subject to a retention-of-title or financial lease; and (c) the procedures for enforcing these types of acquisition financing device. While the scale and scope of the needed transition under the non-unitary approach might not be as great, the issues that arise in practice will be identical to those arising under the unitary approach and the general principles governing adoption of a unitary regime should also apply to the transition to a reformed non-unitary regime.

B. Recommendations

[Note to the Commission: The Commission may wish to note that, as document A/CN.9/631 includes a consolidated set of the recommendations of the draft legislative guide on secured transactions, the recommendations are not reproduced here. Once the recommendations are finalized, they will be reproduced at the end of each chapter.]

A/CN.9/631/Add.10 [Original: English]

**Note by the Secretariat on recommendations of the UNCITRAL draft Legislative
Guide on Secured Transactions, submitted to the Working Group on Security
Interests at its twelfth session**

ADDENDUM

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XIII. Private international law

A. General remarks

1. Introduction

(a) Purpose of private international law rules

1. This chapter discusses the rules for determining the law applicable to the creation, effectiveness against third parties (“third-party effectiveness”), priority as against the rights of competing claimants and enforcement of a security right (for the definitions of the terms “security right”, “priority” and “competing claimant”, see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation). These rules are generally referred to as private international law rules (or conflict-of-laws rules) and also determine the territorial scope of the substantive rules envisaged in the Guide (i.e. if and when the substantive rules of the State enacting the regime envisaged in the Guide apply). For example, if a State has enacted the substantive law rules envisaged in the Guide relating to the priority of a security right, those rules will apply to a priority contest arising in the enacting State only to the extent that the private international law rule on priority issues points to the laws of that State. Should the private international law rule provide that the law governing priority is that of another State, then the relative priority of competing claimants will be determined in accordance with the law of that other State.

2. The private international law rules proposed in the Guide will apply only if the forum is in a State that has enacted the recommendations of the Guide. They cannot apply in another State if the latter is not an enacting State. This is so because a State cannot legislate on the private international law rules to be applied in another State. The courts of the other State apply their own private international law rules. In order to determine whether to apply its domestic law or the law of another State, the court needs to determine whether a case is a domestic or an international case. This in itself may be considered as an issue of private international law. Unlike the United Nations Convention on the Assignment of Receivables in International Trade¹ (hereinafter referred to as the “United Nations Assignment Convention”), which defines “internationality”, the Guide does not address the question, but rather leaves it to other law of the forum. In any case, for the law of a State to which private

¹ United Nations publication, Sales No. E.04.V.4.

international law rules point to apply, there has to be a connection with that State. The main connecting factors addressed in this chapter are the location of the assets and the location of the grantor of a security right.

3. After a security right has been created and has become effective against third parties, a change might occur in the connecting factor. For instance, if the third-party effectiveness of a security right in inventory located in State A is governed under the private international law rules of State A by the law of the location of the inventory, the question arises as to what happens if part of the inventory is subsequently moved to State B (whose private international law rules also provide that the law of the location of tangible property governs the third-party effectiveness of security rights in tangible property). One approach would be for the security to continue to be effective in State B without the need to take any further step in State B. Another approach would be for new security to be obtained under the laws of State B. Yet another approach would be for the secured creditor's pre-existing right to be preserved subject to the fulfilment in State B of certain formalities within a certain period of time (e.g. 30 days after the goods have been brought into State B). As this is a matter of substantive law rather than private international law, the Guide addresses it in chapter V (see A/CN.9/631, recommendation 46). This chapter deals only with the time that is relevant for the determination of the location of an asset or the grantor for the purpose of determining whether a security right has been created, made effective against third parties and obtained priority over another right (see A/CN.9/631, recommendation 216).

4. In an efficient secured transactions regime, private international law rules applicable to secured transactions normally reflect the objectives of the secured transactions regime. This means that the law applicable to the property aspects of a security right should be capable of easy determination. Certainty is a key objective in the development of rules affecting secured transactions both at the substantive and the private international law levels. Another objective is predictability. As illustrated by the example mentioned in the preceding paragraph, private international law rules should provide an answer to the question of whether a security right acquired under the law of State A remains subject to that law or becomes subject to the law of State B if a subsequent change in the connecting factor would point to the law of State B for a security right of the same type. A third key objective of an efficient private international law system is that the relevant rules reflect the reasonable expectations of interested parties (i.e. creditor, grantor, debtor and third parties). In order to achieve this result, it is arguable that the law applicable to a security right should have some connection to the factual situation that will be governed by such law.

5. Use of the Guide (including this chapter) in developing secured transactions laws will help to reduce the risks and costs resulting from divergences among current private international law regimes. In a secured transaction, the secured creditor normally wants to ensure that its rights will be recognized in all States where enforcement might take place (including in a jurisdiction administering an insolvency proceeding with respect to the grantor and its assets). If those States have different private international law rules in relation to the same type of encumbered asset, the creditor will need to comply with more than one regime in order to be fully protected. A benefit of different States having harmonized their

private international law rules is that a creditor can rely on the same private international law rule (leading to the same results) to determine the status of its security in all those States. This is one of the goals achieved in respect of receivables by the United Nations Assignment Convention and in respect of indirectly held securities by the Convention on the Law Applicable to Certain Rights in respect of Securities held with an Intermediary, adopted by the Hague Conference on Private International Law in December 2002 (hereinafter the “Hague Securities Convention”).

6. Private international law rules would be necessary even if all States had harmonized their substantive secured transactions laws. There would remain instances where the parties would have to identify the State whose requirements will apply. For example, if the laws of all States provided that a non-possessory right is made effective against third parties by registration of a notice in a public registry, one would still need to know in which State’s registry the registration must be made.

(b) Scope of private international law rules

7. This chapter does not define the security rights to which the private international law rules will apply. Normally, the characterization of a right as a security right for private international law purposes will reflect the substantive secured transactions law in a jurisdiction. In principle, a court will use its own law whenever it is required to characterize an issue for the purpose of selecting the appropriate private international law rule. The question arises, however, as to whether the private international law rules of a State relating to security rights should also apply to other transactions that are functionally similar to security, even if they are not covered by the substantive secured transactions regime of that State (e.g. retention-of-title sales, financial leases and other similar transactions). The fact that the substantive secured transactions law of a State might not apply to those other transactions should not preclude the State from applying to those transactions the private international law rules applicable to secured transactions.

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

9. Whatever decision a jurisdiction makes on the range of transactions covered by the private international law rules, the scope of the rules on creation, third-party effectiveness and priority of a security right will be confined to the property aspects of the relevant transactions. Thus, a rule on the law applicable to the creation of a security right only determines what law governs the requirements to be met for a

property right to be created in the encumbered assets. The rule would not apply to the personal obligations of the parties under their contract. In most legal systems, purely contractual obligations are generally subject to the law chosen by the parties in their agreement or, in the absence of such a choice, by the law governing the security agreement (e.g. the Convention on the Law Applicable to Contractual Obligations,² concluded in Rome in 1980, hereinafter the “Rome Convention”). The Guide recommends the same approach for the determination of the mutual rights and obligations of the grantor and the secured creditor with respect to the security right.

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

11. The private international law rules of many legal systems now provide that reference to the law of another State as the law governing an issue refers to the law applicable in that State other than its private international law rules (see, however, A/CN.9/631, recommendations 219, subpara. (b), and 220). The doctrine of renvoi is excluded, for the sake of predictability and also because renvoi may run contrary to the expectations of the parties. The Guide adopts the same approach (see A/CN.9/631, recommendation 217).

2. Private international law rules for the creation, third-party effectiveness and priority of a security right

12. The determination of the extent of the rights conferred by a security right generally requires a three-step analysis, as follows:

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

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

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

13. Indeed, a security right is of little practical value if it cannot be efficiently enforced. This question does not, however, relate to the extent of the rights that the secured creditor has in the encumbered assets and the private international law rules on enforcement will be discussed in another section of this chapter.

14. Not all legal systems draw a distinction between effectiveness of a security right between the parties and effectiveness against third parties (and priority). In

² United Nations, *Treaty Series*, vol. 1605, No. 28023.

many legal systems, a validly created security right (or other property right) is by definition effective against all (*erga omnes*) without any further action. In those legal systems, the same private international law rule applies to the effectiveness of a security right against all (and priority may be analysed also as an issue of effectiveness). However, even legal systems that clearly distinguish among effectiveness as between the parties, effectiveness against third parties and priority do not always establish a separate private international law rule for each of those issues and thus the same private international law rule may apply to all the three issues leading to the application of the same substantive law rule.

15. Therefore, the key question is whether one single private international law rule should apply to all three issues. Policy considerations, such as simplicity and certainty, favour the application of one private international law rule. As noted above, the distinction among these issues is not always made or understood in the same manner in all legal systems, with the result that providing different private international law rules on these issues may complicate the analysis or give rise to uncertainty. There are, however, instances where selecting a different law for priority issues would better take into account the interests of third parties such as persons holding statutory security or similar rights (such as a judgement creditor or an insolvency administrator).

16. Another important question is whether on any given issue (i.e. creation, third-party effectiveness or priority) the relevant private international law rule should be the same for tangible and intangible property. A positive answer to that question would favour either a rule based on the law of the location of the grantor or a rule based on the law of the location of the encumbered assets (*lex situs* or *lex rei sitae*).

17. An approach based on the *lex situs* would be inconsistent in respect of receivables with the United Nations Assignment Convention (article 22 of which refers to the law of the State in which the assignor, i.e. the grantor, is located). Moreover, as intangible property is not capable of physical possession, adopting the *lex situs* as the applicable private international law rule would require the development of special rules and legal fictions for the determination of the actual situation of the various types of intangible property. For this reason, the Guide does not consider the location of the asset as being the appropriate connecting factor for intangible property and favours an approach generally based on the law of the location of the grantor (see A/CN.9/631, recommendation 204).

18. In addition, consistency with the United Nations Assignment Convention would dictate defining the location of the grantor in the same way as in the Convention. Under the Convention, the grantor's location is its place of business or, if the grantor has places of business in more than one State, the place where the central administration of the grantor is exercised. If the grantor has no place of business, reference is then made to the grantor's habitual residence (see art. 5, subpara. (h) of the Convention). This approach was followed in the Convention mainly because it results in the application of a single law that is easy to determine and is the law of the State in which the main insolvency proceeding with respect to the assignor will most likely be opened.

19. Simplicity and certainty considerations could even support the adoption of the same private international law rule (e.g. the law of the grantor's location) not only

for intangible property but also for tangible property, especially if the same law were to apply to the creation, third-party effectiveness and priority of a security right. Following this approach, one single enquiry would suffice to ascertain the extent of the security rights encumbering all assets of a grantor. There would also be no need for guidance in the event of a change in the location of encumbered assets or to distinguish between the law applicable to possessory and non-possessory rights (and to determine which prevails in a case where a possessory security right governed by the law of State A competes with a non-possessory security right in the same property governed by the law of State B).

20. Not all jurisdictions, however, regard the law of the location of the grantor as sufficiently connected to security rights in tangible property, at least for “non-mobile” goods (or even in certain types of intangible property, such as rights to payment of funds credited to bank accounts or intellectual property, a matter discussed below). Moreover, adoption of the grantor’s law would result in one law governing a secured transaction and another law governing a transfer of ownership in the same assets. To avoid this result, jurisdictions would need to adopt the grantor’s law for all transfers.

21. In addition, it is almost universally accepted that a possessory right should be governed by the law of the place where the property is held, so that adopting the law of the grantor for possessory rights would run against the reasonable expectations of non-sophisticated creditors. Accordingly, even if the law of the grantor’s location were to be the general rule, an exception would need to be made for possessory security rights.

22. For all these reasons, the Guide recommends two general private international law rules on the law applicable to the creation, third-party effectiveness and priority of a security right, as follows:

(a) With respect to tangible property, the applicable law should be the law of the location of the assets (see A/CN.9/631, recommendation 202);

(b) With respect to intangible property, the applicable law should be the law of the location of the grantor (see A/CN.9/631, recommendation 204).

23. As the private international law rules generally will be different depending on the tangible or intangible character of the assets, the question arises as to which private international law rule is appropriate if intangible property is capable of being the subject of a possessory security right. In this regard, most legal systems assimilate certain categories of intangible property embodied in a document (such as a negotiable instrument) to tangible property, thereby recognizing that a possessory security right may be created in such assets through the delivery of the document to the creditor. The Guide treats these types of intangible property as tangible property (for the definition of “tangible property”, see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation) and, accordingly, the private international law rule for tangible property generally applies to such intangible property. Accordingly, the law of the State where the instrument is held will govern the creation, third-party effectiveness and priority of a security right in a negotiable instrument (see A/CN.9/631, recommendation 202).

24. A related issue arises where goods are represented by a negotiable document of title (such as a bill of lading). It is generally accepted that a negotiable document

of title is also assimilated to tangible property and may be the subject of a possessory pledge. The law of the location of the document (and not of the goods covered thereby) would then govern the pledge. The question arises, however, as to what law would apply to resolve a priority contest between a pledgee of a document of title and another creditor to whom the debtor might have granted a non-possessory security right in the goods themselves, if the document and the goods are not held in the same State. In such a case, the private international law rules should accord precedence to the law governing the pledge, on the basis that this solution would better reflect the legitimate expectations of interested parties. This result would also be consistent with the substantive rule proposed by the Guide (see A/CN.9/631, recommendation 107).

3. Law applicable to the creation, third-party effectiveness and priority of a security right in tangible property

25. The policy considerations favouring the general private international law rules set out above (see para. 22) do not necessarily apply in all circumstances and other rules apply with respect to certain specified types of asset for which the location of the asset or of the grantor is not the most appropriate connecting factor. In addition, for efficiency purposes, alternative rules apply with respect to goods in transit and export goods. Such goods are not intended to remain in their initial location and may cross the borders of several States before reaching their ultimate destination. The following paragraphs explain the two general private international law rules outlined above and their exceptions.

(a) General rule: law of the location of the encumbered asset (*lex situs* or *lex rei sitae*)

26. As mentioned above, the creation, the effectiveness against third parties and the priority of a security right in tangible property are generally governed by the law of the State in which the encumbered asset is located (see A/CN.9/631, recommendation 202). A frequent example of the application of the rule relates to security rights in inventory. If a grantor owns inventory located in a State that has this rule (State A), the law of that State will govern those issues. The rule also means that, if the grantor also owns other inventory in another State (State B), the relevant requirements of State B will have to be fulfilled in order for the courts of State A to recognize that the inventory located in State B is subject to the secured creditor's rights.

27. The general private international law rule for tangible property does not make a distinction between possessory security rights and non-possessory security rights. Accordingly, the law of the location of the asset will generally apply, whether or not the secured creditor has possession of the asset. This is particularly relevant for intangible property assimilated to tangible property, such as negotiable instruments and negotiable documents. For instance, the law of the location of the instrument or document will govern priority matters even if the security right is made effective against third parties otherwise than by possession.

(b) Additional rule for the creation and third-party effectiveness of a security right in goods in transit and export goods

28. With respect to goods in transit or goods intended for export, application of the law of the location of the goods results in the application of the law of the State in which the goods are located at the time an issue arises. This means that secured creditors have to monitor the assets and follow the requirements of various States to ensure that they have at all times an effective security right. To avoid that result, one approach would be for the forum in the ultimate (or intermediate) destination to recognize as effective a security right created and made effective against third parties under the law of the initial location. Such an approach would reflect the expectations of parties in the initial location of the goods, but would be contrary to the expectations of parties that relied on the actual location of the assets and provided credit to the grantor following the requirements of the law of the ultimate destination of the goods.

29. Another approach would be for the forum in the ultimate destination to recognize as effective a security right created and made effective against third parties under the law of the initial location of the goods for a limited period of time. Parties in the initial destination could then have a period of time to follow the requirements of the law of the State of the ultimate destination to retain their security right as originally created and made effective against third parties. Such an approach would balance the interests of parties in the various jurisdictions (and is in fact recommended in the Guide in general for all tangible property; see A/CN.9/631, recommendations 46 and 216).

30. A further approach would be to offer to the secured creditor the option of creating and making its security right effective against third parties under the law of the State of the initial location of the goods or under the law of the State of the ultimate (or intermediate) location of the goods (see A/CN.9/631, recommendation 203). This approach would allow a secured creditor that is confident that the goods will reach the place of their intended destination to rely on the law of that place to create and make its security right effective against third parties. Otherwise, in the case of a security right created while the goods are at their initial location, for the security right to be continuously effective against third parties, the secured creditor would have to fulfil the creation and third-party effectiveness requirements of the place of the initial location, of each State where the goods could be in transit and of the place of ultimate destination. In any case, priority would always be subject to the law of the location of the goods at the time a priority dispute arises.

(c) Special rule for the creation, third-party effectiveness and priority of a security right in a negotiable instrument

31. As mentioned above, it is generally accepted that the law of the State in which the instrument is located (*lex situs*) should govern the creation, third-party effectiveness and priority of a security right in a negotiable instrument. However, in some legal systems, the third-party effectiveness of a security right in negotiable instruments may also be achieved by registration in the place in which the grantor is located. In such a case, it is logical to rely on the law of the State of the grantor's location to determine whether third-party effectiveness has been achieved by registration. In any case, this approach is confined to third-party effectiveness

achieved by registration. The law of the actual location of the instrument always governs the priority of a security right in the instrument (see A/CN.9/631, recommendation 207).

(d) Exceptions for certain types of asset

32. The general private international law rule for security rights in tangible property is normally subject to certain exceptions where the location of the property would not be an efficient connecting factor (e.g. goods ordinarily used in several States) or would not correspond to the reasonable expectations of the parties (e.g. goods the ownership of which must be recorded in special registries).

(i) Mobile goods

33. Mobile goods are goods that in the normal course of business cross the borders of States (e.g. aircraft, ships or, in some cases, motor vehicles). For example, a grantor operating a construction business in several States may have to create security rights in machinery periodically moved from one State to another for the purposes of that business; or a grantor operating a transportation business may need to create security rights in the vehicles used in the transportation business (although motor vehicles may not normally cross national borders in island States). The application of the general private international law rule for tangible property of that kind would require the secured creditor to ascertain the exact location of each piece of machinery or each vehicle at the time of the creation of the security. To ensure continued third-party effectiveness of its security, the secured creditor would also need to enquire as to all States in which each of these assets might be potentially located at any given time and meet the relevant requirements of all such States. Moreover, it would not be possible to identify the State in which the relevant asset would be located at the time of a priority contest occurring in the future and therefore to determine the priority regime to be applied to resolve the dispute. To avoid these problems and resulting costs and uncertainties, in many legal systems, the creation, third-party effectiveness and priority of a security right in tangible property of a type ordinarily used in more than one State are governed by the law of the State in which the grantor is located (except if ownership of property of that type is subject to registration in a special registry which also allows for the registration of security rights; see para. 34 below; see also A/CN.9/631, recommendation 202).

(ii) Tangible property subject to specialized registration

34. The ownership of certain categories of tangible property is sometimes recorded in specialized registries. This is generally the case for aircraft and ships and, in some States, for motor vehicles. To the extent that the relevant registry also permits the registration of security rights, reference can be made to the law of the State under the authority of which the relevant registry is maintained to determine the law governing the creation, third-party effectiveness and priority of a security right in an asset that is subject to registration in such a specialized registry. Thus, a search in the registry would disclose both ownership and security rights in respect of such assets. Such a rule may be based on national law (see A/CN.9/631, recommendation 202) or international conventions, which take precedence (e.g. the

International Institute for the Unification of Private Law (Unidroit) Convention on International Interests in Mobile Equipment and the relevant protocols thereto).

4. Law applicable to the creation, third-party effectiveness and priority of a security right in intangible property

(a) General rule: law of the location of the grantor

35. In some legal systems, the law of the State in which the grantor is located governs the creation, third-party effectiveness and priority of a security right in intangible property. For instance, if an exporter located in State A creates a security right in receivables owed by customers located in States B and C, the law of State A will govern the property right aspects of the security right. This rule is consistent with the approach followed in the United Nations Assignment Convention with respect to the law applicable to the assignment of receivables (see arts. 22 and 30).

36. In other legal systems, the law of the location of the asset still governs the creation, third-party effectiveness and priority of a security right in intangible assets. In those legal systems, it is necessary to establish the location of an intangible asset (e.g. for a receivable, the location of the debtor of the receivable). In those legal systems, the law of the location of the intangible asset (*lex situs*) governs all those matters.

37. The law of the grantor's location has several advantages over the *lex situs*. It is one law, as the assignor is always one and the same person even if the assignment relates to many receivables owed by different debtors (subsequent assignments, from A to B and from B to C, do not raise priority issues, as one assignor takes the place of another). In addition, the law of the grantor's location may be ascertained easily at the time the assignment is made, even if the assignment relates to future receivables or to receivables assigned in bulk. Moreover, the law of the grantor's location (place of central administration in the case of places of business in more than one State) is the law of the State in which the main insolvency proceeding with respect to the assignor is likely to be opened.

38. Moreover, while the law of the location of the encumbered asset (*lex situs*) works well in most instances for tangible property, great difficulties arise in applying the *lex situs* to intangible property, both at conceptual and practical levels. From a conceptual standpoint, there is no consensus and no clear answer as to the *situs* of a receivable. One view is that it is the place where payment must be made. Another view is that the *situs* of a receivable is the legal domicile or place of business or principal residence of the debtor of the receivable. A further view is that a receivable should be deemed to be located in the State whose law governs the contractual relationship between the original creditor (that is, the grantor) and the debtor. Any of the foregoing alternatives would impose upon a prospective assignee the burden of having to make a detailed factual and legal investigation. Moreover, in many instances, it might prove impossible for the assignee to determine with certainty the exact location of a receivable since the criteria for determining that location may depend on business practices or the will of the parties to the contract under which the receivable arises. Thus, using the *lex situs* as the law applicable to security rights involving receivables would not provide certainty and predictability, which are key objectives for a sound private international law regime in the area of secured transactions.

39. Furthermore, even if a legal system has detailed provisions allowing a prospective or existing secured creditor to ascertain easily and objectively the law of the location of a receivable, practical difficulties still ensue in many commercial transactions. This would be so because a security right may relate not only to an existing and specifically identified receivable, but also to many other receivables. Thus, a security right may cover a pool of present and future receivables. For instance, in such a case, selecting the *lex situs* as the law governing priority would not be an efficient policy decision, as different priority rules might apply with respect to the various assigned receivables. Moreover, where future receivables are subject to a security right, it would not be possible for the secured creditor to ascertain the extent of its priority rights at the time of the transaction, since the *situs* of those future receivables is unknown at that time.

40. In view of the above, the Guide recommends the law of the State in which the grantor is located (see A/CN.9/631, recommendation 204). The criteria defining the grantor's location are consistent with those found in the United Nations Assignment Convention (see A/CN.9/631, recommendation 215).

(b) Exceptions for certain types of asset

41. There are three categories of intangible property to which different considerations apply and the location of the grantor is not the most (or the only) appropriate connecting factor for the selection of the applicable law: rights to payment of funds credited to a bank account; proceeds under an independent undertaking; and receivables arising from a transaction relating to immovable property.

(i) Rights to payment of funds credited to a bank account

42. With respect to the creation, third-party effectiveness, priority and enforcement of a security right in rights to payment of funds credited to a bank account, as well as the rights and obligations of a depositary bank, different approaches are followed in various legal systems (for the definition of "bank account", see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation). One approach is to refer those matters to the law of the State in which the branch maintaining the account is located. Under this approach, certainty and transparency with regard to the applicable law would be enhanced, as the location of the relevant branch could be easily determined in a bilateral bank-client relationship. In addition, such an approach would reflect the normal expectations of parties to current banking transactions. Moreover, this approach would result in the application of the same law to all issues (e.g. loans and tax or regulatory matters) relating to banking activities.

43. Another approach is to refer to the law specified in the account agreement as the law governing the account agreement or to any other law explicitly specified in the account agreement, provided that the depositary bank has a branch in that State. If the account agreement does not specify any law, the applicable law would be determined using the same default criteria as those found in article 5 of the Hague Securities Convention. Under this approach, the applicable law would meet the expectations of the parties to the account agreement. In addition, the need to identify the location of a bank account, which might not be easy to determine, would be avoided. Moreover, third parties would be able to ascertain the law

provided in the account agreement, as the grantor-account holder would normally supply information on the account agreement to obtain credit from a lender relying on the funds in the account.

44. As is the case with negotiable instruments, the law of the State of the grantor's location could apply to the third-party effectiveness of a security right in a right to payment of funds credited to a bank account where third-party effectiveness may be achieved by registration in the place where the grantor has its location (see para. 31 above).

(ii) *Proceeds under an independent undertaking*

45. In many legal systems, the third-party effectiveness, priority and enforcement of a security right in proceeds under an independent undertaking, as well as the rights and duties of a guarantor/issuer, confirmer or nominated person, are referred to the law specified in the independent undertaking (for the definition of "right in proceeds under an independent undertaking", see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation; for this approach, see A/CN.9/631, recommendation 208). If the governing law is not specified in the independent undertaking, those matters are referred to the law of the State of the location of the relevant office of the person that has provided (or has agreed to perform, as the case may be) the undertaking (see A/CN.9/631, recommendation 209). This approach provides certainty and predictability with respect to the law applicable to those matters. It is also consistent with the normal expectations of parties to such transactions. As to the creation of a security right in such an asset, reference is made to the law of the grantor's location, for the reasons discussed above with respect to security rights in receivables and in view of the fact that creation involves just the effectiveness of the security right as between the parties to the security agreement and does not affect the rights of third parties.

46. With the exception of creation, the matters mentioned in the preceding paragraph are governed by the law governing a receivable or negotiable instrument, if an independent undertaking is issued to ensure the performance of an obligation under the receivable or the negotiable instrument and, under the applicable law, the creditor with a right in the receivable, negotiable instrument or other intangible asset automatically has the benefit of the security right in the proceeds under the independent undertaking (see A/CN.9/631, recommendation 210). This approach is justified by the need to have, for consistency reasons, the same law apply to the security right in a receivable or negotiable instrument extending automatically to rights securing the performance of the receivable or negotiable instrument.

(iii) *Receivables related to immovable property*

47. Where a receivable arises from the sale or lease of immovable property or is secured by immovable property, as for any other receivable, the law of the State of the location of the grantor will normally govern the property aspects of a security right in the receivable. However, in the event of a priority contest where at least one of the competing claimants has registered its right in the immovable property registry of the State in which the property is located, the priority contest will be resolved in accordance with the law of that State (see A/CN.9/631, recommendation 205).

5. Law applicable to the creation, third-party effectiveness and priority of a security right in proceeds

48. There are generally two approaches to the law applicable to the creation, third-party effectiveness and priority of a security right in proceeds (for the definition of “proceeds”, see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation).

49. One approach is to refer for the law applicable to a security right in proceeds to the law applicable to the security right in the original encumbered assets. For example, if the original encumbered assets are in the form of inventory located in State A and the proceeds take the form of receivables and the grantor is located in State B, the law of State A would apply to the creation, third-party effectiveness and priority of a security right in receivables. In particular, a priority conflict between a security right in receivables as proceeds of inventory and a security right in receivables as original encumbered assets would be governed by the law of State A (the law of the location of the inventory). As a result, certainty as to the applicable law would be enhanced for the benefit of the inventory financiers relying on the receivables as proceeds. On the other hand, this approach would result in the application of a law other than the law receivables financiers would expect to apply to their rights in the receivables as original encumbered assets.

50. Another disadvantage of this approach is that the receivables financier would be unable to predict what the applicable law would be because the choice of the governing law would depend on whether the dispute arises with an inventory financier (in which case the law of the location of the inventory would govern) or with another competing claimant (in which case the law of the location of the grantor would govern). This approach also provides no solution in a tripartite dispute among the receivables financier, the inventory financier and another competing claimant. This approach would also undermine the choice of the law of the grantor’s location as the law applicable to a security right in receivables because receivables often result from the sale of tangible assets. The receivables financier in many instances then would be unable to rely on the law of grantor’s location.

51. Another approach is to refer to the law applicable to security rights in assets of the same type as the proceeds. In the example given above, the law of State B (the law of the grantor’s location) would apply to the creation, third-party effectiveness and priority of a security right in the receivables. Simplicity and certainty considerations would support such an approach. The benefit of this approach is that it would always be possible to determine the applicable law irrespective of the parties to the dispute.

52. Yet another approach is to combine the two approaches mentioned above and have the latter approach as the rule for third-party effectiveness and priority of a security right in proceeds, while the former approach would apply to the creation of that right. Under this approach, the question of whether a security right extends to proceeds would be governed by the law applicable to the creation of a right in the original encumbered assets from which the proceeds arose, while the third-party effectiveness and priority of an entitlement to proceeds would be subject to the law that would have been applicable to such issues if the proceeds had been original encumbered assets. This approach would meet the expectations of a creditor obtaining a security right in inventory under a domestic law providing that such

security right automatically extends to proceeds. It would also meet the expectations of receivables financiers as to the law that would apply to the creation, third-party effectiveness and priority of a security right in receivables as original encumbered assets. Finally, such an approach would ensure that the inventory financier could rely on the law governing its security right as to whether the right extends to proceeds and would allow all competing claimants to identify with certainty the law that will govern a potential priority contest (see A/CN.9/631, recommendation 211).

6. Law applicable to the rights and obligations of the parties to the security agreement

53. As mentioned above (see para. 9), the scope of the rules on the creation, third-party effectiveness and priority of a security right is confined to the property (*in rem*) aspects of the right. These rules do not apply to the mutual rights and obligations of the parties to the security agreement. Such rights and obligations are rather governed by the law chosen by them or, in the absence of a choice of law, by the law governing the agreement as determined by the private international law rules generally applicable to contractual obligations (see A/CN.9/631, recommendation 212). For example, in the absence of a choice of law by the parties, the mutual rights and obligations of the parties to the security agreement may be subject to the law most closely connected to the security agreement (see art. 4, para. 1, of the Rome Convention). A security agreement securing a loan may be presumed to be most closely connected with the State in which the party that performs the obligation that is characteristic of the security agreement has its central administration or habitual residence (see art. 4, para. 2, of the Rome Convention). In such a security agreement, this party may be the lender. In a retention-of-title sale, it may be the seller.

7. Law applicable to the rights and obligations of third-party obligors

54. Security rights in intangible property generally involve third parties such as, for example, the debtor of a receivable, the obligor under a negotiable instrument, the depositary bank, the guarantor/issuer, confirmer or nominated person in an independent undertaking or the issuer of a negotiable document. The private international law rules governing the property aspects or the enforcement of a security right are not necessarily appropriate for the determination of the law applicable to the obligations of third parties against whom the secured creditor may want to exercise the remedies arising from its security right. The main reason is to avoid frustrating the expectations of parties that have a payment obligation arising in connection with the encumbered asset but do not take part in the transaction to which the security agreement relates.

55. In particular, the fact that a receivable has been encumbered by a security right should not result in the obligations of the debtor of the receivable becoming subject to a law different from the law governing the receivable. Similar considerations apply to rights of the obligor under a negotiable instrument, the depositary bank, the guarantor/issuer, confirmer or nominated person in an independent undertaking or the issuer of a negotiable document where the encumbered asset is a negotiable instrument, right to payment of funds credited to bank accounts or proceeds under an independent undertaking, or a negotiable document (see A/CN.9/631, recommendations 206, 208 and 213).

8. Law applicable to the enforcement of a security right

56. In most legal systems, procedural matters are governed by the law of the State where the relevant procedural step is taken. However, enforcement may relate to substantive or procedural matters. Although a court would use its own law to determine what is substantive and what is procedural, the following are examples of issues generally considered to be substantive: the nature and extent of the remedies available to the creditor to realize the encumbered assets; whether such remedies (or some of them) may be exercised without judicial process; the conditions to be met for the secured creditor to be entitled to obtain possession and dispose of the assets (or to cause the assets to be judicially realized); the power of the secured creditor to collect receivables that are encumbered assets; and the obligations of the secured creditor to the other creditors of the grantor.

57. So, with respect to substantive enforcement matters, where a security right is created and made effective against third parties under the law of one State, but is sought to be enforced in another State, the question arises as to the law applicable and thus the remedies available to the secured creditor. This is of great practical importance where the substantive enforcement rules of the two States are significantly different. For example, the law governing the security right could allow enforcement by the secured creditor without prior recourse to the judicial system unless certain conditions for the protection of the grantor are met, while the law of the place of enforcement might require judicial intervention. Each of the possible solutions to this issue entails advantages and disadvantages.

58. One approach would be to refer enforcement remedies to the law of the place of enforcement, i.e. the law of the forum (*lex fori*). The place of enforcement of security rights in tangible property in most instances would be the place of the location of the asset, while enforcement of a security right in intangible property would often take place in the location of the grantor. The policy reasons in favour of this rule include that:

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

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

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

59. On the other hand, selecting the *lex fori* may result in uncertainty if the encumbered asset consists of intangible property. For example, it is not clear where enforcement is to take place if the encumbered assets are in the form of receivables. The answer to this question would be very problematic as it would require the criteria for determining the location of the receivables to be set out (see para. 38 above). In addition, the secured creditor might be located in a different State at the time the initial enforcement steps are taken. In the case of a bulk assignment involving receivables connected with several States, multiple laws may apply to enforcement. The result would be the same if one enforcement act would

have to be performed in one State (e.g. notification of the debtor of the receivable) and another act in another State (e.g. collection or sale of the receivable). If future receivables are involved, the secured creditor may not know at the time of the assignment which law would govern its enforcement remedies. All this uncertainty as to the applicable law is likely to have a negative impact on the availability and the cost of credit.

60. Another concern is that the *lex fori* might not give effect to the intention of the parties. The parties' expectations may be that their respective rights and obligations in an enforcement situation will be those provided by the law under which the priority of the security right will be determined. For example, if extrajudicial enforcement is permitted under the law governing the priority of the security right, this remedy should also be available to the secured creditor in the State where it has to enforce its security right, even if it is not generally allowed under the domestic law of that State.

61. So, another approach would be to refer substantive enforcement matters to the law governing the priority of the security right. The advantage of such an approach would be that such matters are closely connected with priority issues (e.g. the manner in which a secured creditor will enforce its security right may have an impact on the rights of competing claimants). Such an approach may have another benefit. As the law governing priority is often the same law as the law governing the creation and third-party effectiveness of the security right, the end result would be that creation, third-party effectiveness, priority and enforcement issues would often be governed by the same law.

62. A third possible approach would be to adopt a rule whereby the law governing the contractual relationship of the parties would also govern enforcement matters. This would often correspond to their expectations and, in many instances, would also coincide with the law applicable to the creation of the security right since that law is often selected as also being the law of their contractual obligations. However, under this approach, parties would then be free to select, for enforcement issues, a law other than the law of the forum or the law governing creation, third-party effectiveness and priority. This solution would be disadvantageous to third parties that might have no means to ascertain the nature of the remedies that could be exercised by a secured creditor against the property of their common debtor.

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

64. Another approach would be to attempt to reconcile the benefits of the approaches based on the *lex fori* and the law governing priority. Under this approach, the enforcement of a security right in tangible property may be governed by the *lex fori*, while the enforcement of a security right in intangible property would be governed by the same law as the law that applies to priority (see A/CN.9/631, recommendation 214).

9. Rules and relevant time for the determination of location

65. As the general private international law rules for security rights in tangible and intangible property point to the location of the encumbered assets and the location

of the grantor, respectively, it is essential that the appropriate location be easily identified. Tangible property is commonly viewed as being located at the place where it is physically located and there is no need to provide a specific rule to that effect. There is such a need, however, for the determination of the location of the grantor. The legal domicile and the residence of a natural person might be in different States. Likewise, a legal person may have its statutory head office in a State other than the State in which its principal place of business or decision centre is located.

66. As mentioned above, the United Nations Assignment Convention defines the location of the grantor as follows: the grantor's location is its place of business or if the grantor has places of business in more than one State, the place where the central administration of the grantor is exercised. If the grantor has no place of business, reference is then made to the grantor's habitual residence (see art. 5, subpara. (h)). The Guide defines the location of the grantor in the same manner (see A/CN.9/631, recommendation 215).

67. Whatever connecting factor is retained for determining the most appropriate private international law rule for any given issue, there may be a change in the relevant factor after a security right has been created. For example, where the applicable law is that of the jurisdiction where the grantor has its head office, the grantor might later relocate its head office to another jurisdiction. Similarly, where the applicable law is the law of the jurisdiction where the encumbered assets are located, the assets may be moved to another jurisdiction. So, it is necessary to determine the time that is relevant for the determination of location.

68. If this issue is not dealt with specifically, the general private international law rules on creation, third-party effectiveness and priority might be construed to mean that, in the event of a change in the relevant connecting factor, the original governing law continues to apply to creation issues (because they arose before the change, while the subsequent governing law would apply to events occurring thereafter that raise third-party effectiveness or priority issues). For instance, in a situation where the law applicable to the third-party effectiveness of a security right is that of the grantor's location, the effectiveness of the right against the insolvency administrator of the grantor would be determined using the law of the State of the new location of the grantor at the time of commencement of the insolvency proceedings.

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

70. Therefore, providing guidance on these issues would appear to be necessary to avoid uncertainty, as a change in the connecting factor will result in the application of a law other than the law expected by the parties to apply if the law of the new location of the assets or the grantor has a different private international law rule. Normally, for the purpose of determining the law applicable to creation, the relevant location is the location of the encumbered asset or the grantor at the time of

creation. For the purpose of determining the law applicable to third-party effectiveness and priority, the relevant location is the location at the time the issue arises (see A/CN.9/631, recommendation 216).

10. Public policy and internationally mandatory rules

71. According to generally applicable private international law rules, the forum may refuse the application of the law applicable under its private international law rules only if the effect of its application would be manifestly contrary to the public policy of the forum State or in a situation where such effects are contrary to mandatory provisions of the law of the forum. This rule is intended to preserve fundamental principles of justice of the forum State. For example, if, under the law of the forum State, a security right cannot be created in retirement benefits and this is a matter of public policy or mandatory law in the forum State, the forum State may refuse to apply a provision of the applicable law that would recognize such a right. However, the forum may not apply instead its own law to third-party effectiveness or priority issues, unless the law of the forum is the applicable law (see A/CN.9/631, recommendation 218). This approach is justified by the need to avoid undermining certainty with respect to the law applicable to third-party effectiveness and priority. The same approach is followed in articles 23, paragraph 2, 30, paragraph 2, and 31 of the United Nations Assignment Convention. It is also followed in article 11, paragraph 3, of the Hague Securities Convention.

11. Special rules when the applicable law is the law of a multi-unit State

72. The term “State” in the Guide refers to a sovereign State or country. The question arises, however, as to what law applies if on a given issue the private international law rule refers to a State that comprises more than one territorial unit, with each unit having its own system of law in relation to the issue. This could be the case in federal States in which the secured transactions law generally falls under the legislative authority of their territorial units. For the private international law rules to work when the applicable law is the law of such a State (even if the forum is not a multi-unit State), it is necessary to determine the territorial unit whose law will apply.

73. Normally, references to the law of such a State are to the law in effect in the relevant territorial unit, as determined on the basis of the applicable connecting factor (such as the location of the asset or the location of the grantor). For instance, if the applicable law is the law of a multi-unit State with three territorial units (A, B and C), a reference to the law of the location of the grantor as the law applicable to a security right in receivables means a reference to the law of unit A if the place of central administration of the grantor is in unit A (see A/CN.9/631, recommendation 219, subpara. (a)).

74. To preserve the consistency of the internal private international law rules of a multi-unit State, it is generally provided that such rules continue to apply, but only internally (see A/CN.9/631, recommendations 219, subpara. (b), and 220). Using the example given in the preceding paragraph, if a grantor is located in unit A of a multi-unit State, application of the law of unit B would be permitted where the internal conflict rules of unit A would point to the law of unit B as the applicable law. This could be the case if the conflict rules of unit A contemplate (as in the Guide) that the law of the grantor’s location governs the third-party effectiveness

and priority of a security right in receivables but defines location differently. If the location of the grantor as defined in the Guide (that is, the place of central administration) is in unit A but the law of unit A defines the grantor's location as meaning the location of its statutory head office and the head office of the grantor is in unit B, then the third-party effectiveness and priority of the security right in the receivables will be governed by the law of unit B. This appears to be a deviation from the general rule on the exclusion of renvoi (see A/CN.9/631, recommendation 217). However, this "deviation" is limited to internal renvoi, which does not affect certainty as to the applicable law. In the above example, there would be no reference to a law other than that of unit A should the statutory head office of the grantor be located in a State other than the State of which unit A forms part.

75. These rules apply only to issues that, in the relevant multi-unit State, are governed by the laws of its territorial units. These rules would have no impact in a federal State whose constitution provides that secured transaction matters are governed by federal laws. These rules would not apply either if the applicable law is the law of a State with multiple units and multiple jurisdictions in which application of such a renvoi could inadvertently result in uncertainty as to the applicable law.

B. Recommendations

[Note to the Commission: The Commission may wish to note that, as document A/CN.9/631 includes a consolidated set of the recommendations of the draft legislative guide on secured transactions, the recommendations are not reproduced here. Once the recommendations are finalized, they will be reproduced at the end of each chapter.]

A/CN.9/631/Add.11 [Original: English]**Note by the Secretariat on recommendations of the UNCITRAL draft Legislative Guide on Secured Transactions, submitted to the Working Group on Security Interests at its twelfth session****ADDENDUM****CONTENTS**

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XIV. Transition**A. General remarks****1. The need for transition provisions**

1. The rules embodied in new secured transactions legislation may be different from the rules in the law predating the legislation. Those differences will have an obvious impact on secured transactions that will be concluded after the new legislation is enacted. In light of the differences between the old and new legal regimes and the continued existence of transactions and security rights created under the old regime, it is important for the success of the new legislation that it contains fair and efficient rules governing the transition from the old rules to the new rules. A similar need for transition rules is present when, under the private

international law rules of the old regime, the law of a different State governed the creation, effectiveness against third parties or priority of a security right.

2. Two issues related to the transition from the old regime to the new law must be addressed. First, the new legislation should provide the date as of which it will have legal effect (the “effective date”; see A/CN.9/631, recommendation 223). Second, the new legislation should also set forth the extent, if any, to which, after the effective date, the new legislation applies to issues relating to transactions or security rights that existed before the effective date.

3. A number of factors require consideration in determining the effective date of the legislation. Prompt realization of the economic advantages of new legislation must be balanced against the need to avoid causing instability in, or disruption of, the markets that will be governed by new legislation and in allowing the market participants adequate time to prepare for conducting transactions under the new legislation, which may be significantly different from the prior law. Accordingly, a State may conclude that the effective date of new legislation should be some period of time after the enactment of the new legislation in order for these markets and their participants to adjust their transactions to the new rules. In determining the effective date, States might consider: the impact of the effective date on credit decisions; maximization of benefits to be derived from the new legislation; the necessary regulatory, institutional, educational and other arrangements or infrastructure improvements to be made by the State; the status of the pre-existing law and other infrastructure; the harmonization of the new secured transaction legislation with other legislation; constitutional limits to the retroactive effect of new legislation; and standard or convenient practice for the entry into force of legislation (e.g. on the first day of a month).

4. As debts that are secured by rights in the grantor’s property are often payable over a period of time, it is likely that there will be many rights created before the effective date that will continue to exist on and after the effective date, securing debts that are not yet paid. Therefore, as noted above, another important decision that must be made with respect to any new legislation is the extent, if any, to which the new legislation will govern issues relating to transactions entered into prior to the effective date.

5. One approach would be for the new legislation to apply prospectively only and, therefore, not to govern any transactions entered into prior to the effective date. While there might be some appeal in such a solution, especially with respect to issues that arise between the grantor and the secured creditor, such an approach would create significant problems, especially with respect to priority issues. Foremost among those problems would be the necessity of resolving priority disputes between a secured creditor that obtained its security right prior to the effective date and a competing secured creditor that obtained its security right in the same property after the effective date. Because priority is a comparative concept, and the same priority rule must govern the two rights that are being compared, it is not possible for the old rules to govern the priority of the right of the pre-effective-date creditor and the new rules to govern the priority of the right of the post-effective-date creditor. Of course, determining which priority rule to apply to such priority disputes is not without difficulty. Applying the old rules to such priority disputes would essentially delay the effectiveness of some of the most important aspects of the new legislation, with the result that significant economic benefits of the new legislation could be deferred for a substantial period. On the other hand, applying the new rules to such priority disputes might unfairly prejudice

parties that relied on the old law and might also provide an incentive for such parties to object to the new legislation or advocate an unduly delayed effective date.

6. Alternatively, greater certainty and earlier realization of the economic benefits of the new legislation could be promoted by applying the new legislation to all transactions as of the effective date, but with such “transition provisions” as are necessary to assure an effective transition to the new regime without loss of pre-effective-date priority status. Such an approach would avoid the problems identified above and would otherwise fairly and efficiently balance the interests of parties that complied with the old law with the interests of parties that comply with the new law.

2. Issues to be addressed by transition provisions

(a) Generally

7. Because many security rights created before the effective date will continue to exist after the effective date and may come into conflict with security rights created after the effective date, it is important for the new legislation to provide clear transition provisions to determine the extent to which the rules in the new legislation will apply to those pre-existing rights. These transition provisions should appropriately address both the settled expectations of parties and the need for certainty and predictability in future transactions. The transition provisions must address the extent to which the new rules will apply, after the effective date, as between the parties to a transaction creating a security right before the effective date. They must also address the extent to which the new rules will apply, after the effective date, to resolve priority disputes between a holder of a security right and a competing claimant, when either the security right or the right of the competing claimant was created before the effective date.

(b) Disputes before a court or arbitral tribunal

8. When a dispute is in litigation (or a comparable dispute resolution system, such as arbitration) at the effective date, the rights of the parties have sufficiently crystallized so that the effectiveness of a new legal regime should not change the outcome of that dispute. Therefore, such a dispute should not be resolved by application of the new legal regime (see A/CN.9/631, recommendation 224).

(c) Effectiveness of pre-effective-date rights as between the parties

9. When a security right has been created before the effective date of new legislation, two questions arise regarding the effectiveness of that right between the grantor and the creditor. The first question is whether a security right that was not effectively created under old law but fulfils all the requirements for creation of a security right under the new law should become effective on the effective date of the new law. The second question is whether a security right that was effectively created under the old law but does not fulfil the requirements for creation under the new law should become ineffective on the effective date of the new law.

10. With respect to the first question, consideration should be given to making the right effective as of the effective date of the new law, since the parties presumably favoured effectiveness. With respect to the second question, a transition period might be created during which the security right would remain effective between the parties, so that the creditor could take the necessary steps for creation under the new law during the transition period. At the expiration of the transition period, if such

steps had not been taken the right would become ineffective under the new law. On the other hand, a simpler approach would be to have all issues of the effectiveness between the parties of a security right created before the effective date governed by the rules in effect at that time (see A/CN.9/631, recommendation 225).

(d) Effectiveness of pre-effective-date rights as against third parties

11. Different issues arise as to the effectiveness against third parties of a right created before the effective date. As the new legislation will embody public policy regarding the proper steps necessary to make a right effective against third parties, it is preferable for the new rules to apply to the greatest extent possible. It may, however, be unreasonable to expect a creditor whose right was effective against third parties under the previous legal regime of the enacting State (or under the law of the State whose law applied to third-party effectiveness under the private international law rules of the old regime) to comply immediately with any additional requirements of the new law. The expectation would be especially onerous for institutional creditors, which would be required to comply with the additional requirements of the new law simultaneously for large numbers of pre-effective-date transactions.

12. A preferable approach would be for a security right that was effective against third parties under the previous legal regime but would not be effective under the new rules to remain effective for a reasonable period of time (as set forth in the new law) so as to give the creditor time to take the necessary steps under the new law. At the expiration of the transition period, the right would become ineffective against third parties unless it had become effective against third parties under the new law (see A/CN.9/631, recommendation 226).

13. If the right was not effective against third parties under the previous legal regime, but is nonetheless effective against them under the new rules, the right should be effective against third parties immediately upon the effective date of the new rules. Once again, the presumption is that the parties intended effectiveness as between them, and third parties are protected to the full extent of the new rules.

(e) Priority disputes

14. An entirely different set of questions arises in the case of priority disputes because such disputes necessarily involve applying one set of rules to two (or more) different rights created at different times. A legal system cannot simply provide that the priority rule in effect at the time when a security right was created governs priority with respect to that right because such a rule would not provide a coherent answer when one of the rights that is being compared was created under the former regime while the other was created under the new regime. Rather, there must be rules that address each of the following situations: (a) where both rights are created after the effective date of the new legislation; (b) where both rights are created before the effective date; and (c) where one right is created before the effective date and the other right is created after the effective date.

15. The easiest situation is a priority dispute between two rights that were created after the effective date of the new legislation. In that situation, it is obvious that the priority rules in the new legislation should be applied to resolve that dispute.

16. Conversely, if both of the competing rights were created before the effective date of the new legislation (and, accordingly, the relative priority of the two

competing rights in the encumbered assets was established before the effective date of the new rules) and, in addition, nothing (other than the effective date having occurred) has happened that would change that relative priority, stability of relationships suggests that the priority established before the effective date should not be changed. If, however, something occurs after the effective date that would have had an effect on priority even under the previous legal regime (such as a security right becoming effective against third parties or ceasing to be effective against third parties), there is less reason to continue to utilize old rules to govern a dispute that has been changed by an action that took place after the effective date. Therefore, there is a much stronger argument for applying the new rules to such a situation (see A/CN.9/631, recommendations 228-230).

17. The most difficult transition situation involves a priority dispute between one right that was established before the effective date and another right that was established after the effective date. In such a case, while it is preferable to have the new rules govern eventually, it is appropriate to provide a transition rule protecting the status of the creditor whose right was acquired under the old regime while that creditor takes whatever steps are necessary to maintain protection under the new regime. If those steps are taken within the requisite time, the new legislation should provide that creditor with priority to the same extent as would have been the case had the new rules been effective at the time of the original transaction and those steps had been taken at that time (see A/CN.9/631, recommendations 227 and 229).

B. Recommendations

[Note to the Commission: The Commission may wish to note that, as document A/CN.9/631 includes a consolidated set of the recommendations of the draft legislative guide on secured transactions, the recommendations are not reproduced here. Once the recommendations are finalized, they will be reproduced at the end of each chapter.]

**F. Note by the Secretariat on terminology and recommendations of the
UNCITRAL draft Legislative Guide on Secured Transactions, submitted
to the Working Group on Security Interests at its twelfth session**

(A/CN.9/637 and Add.1-8) [Original: English]

A/CN.9/637

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Terminology

[Note to the Commission: The Commission may wish to note that the terminology will be placed in section B of the Introduction of the final text of the Guide, while recommendations will appear after the commentary in each chapter. The terminology is reproduced in this document with the recommendations for ease of reference. The Commission may wish to consider whether the terminology and recommendations should also be reproduced in a separate appendix to the Guide in its final version.]

1. The Guide adopts terminology to express the concepts that underlie an effective secured transactions regime. The terms used are not drawn from any particular legal system. Even when a term appears to be the same as that found in a particular national law (whether secured transactions or any other law), the Guide does not intend to adopt the meaning of the term in that national law. Rather, the Guide provides definitions giving a specific meaning to each key term in order to facilitate precise communication, independent of any particular national legal system, and to enable readers of the Guide to understand its recommendations in a uniform way, providing them with a common vocabulary and conceptual framework.

2. Some recommendations use terms that are defined in those recommendations, while the meaning of some terms defined below is further elaborated in recommendations that use those terms or specific chapters of the Guide. The scope and content of each recommendation depends on the meaning of its defined terms. Thus, legislators may consider using the definitions in order to avoid unintended substantive changes, maximize uniform interpretation of the new legislation and promote harmonization of secured transactions law.

3. The word “or” is not intended to be exclusive; use of the singular also includes the plural and vice versa; “include” and “including” are not intended to indicate an exhaustive list; “may” indicates permission and “should” indicates instruction; and “such as” and “for example” are to be interpreted in the same manner as “include” or “including”. “Creditors” should be interpreted as including both the creditors in the enacting State and foreign creditors, unless otherwise specified. References to “person” should be interpreted as including both natural and legal persons, unless otherwise specified.

4. Some States may choose to implement the recommendations of the Guide by enacting a single comprehensive statute (a method more likely to produce coherence and avoid errors of omission or misunderstanding), while other States may seek to modify their existing body of law by insertion of specific rules in various statutes. The Guide refers to the entire body of recommended rules, whichever method is chosen for implementation, as “the law” or “this law”.

5. The Guide also uses the term “law” in various other contexts. Except when otherwise expressly provided, throughout the Guide: (a) all references to law refer to both statutory and non-statutory law; (b) all references to law refer to domestic law, excluding conflict-of-laws rules (so as to avoid renvoi); (c) all references to “other law” refer to the entire body of a State’s law (whether substantive or procedural) other than that embodying the law governing secured transactions (whether pre-existing or newly enacted or modified pursuant to the recommendations of the Guide); (d) all references to “the law governing negotiable instruments” refer not only to a special statute or body of law denominated as “negotiable instruments law” but include also all contract and other general law that might be applicable to transactions or situations involving a negotiable instrument (the same rule applies to similar expressions); and (e) all references to “insolvency law” are similarly all-encompassing, but refer only to law that might be applicable after the commencement of insolvency proceedings.

6. The following subparagraphs identify the principal terms used and the core meaning given to them in the Guide. The meaning of these terms is further refined when they are used in subsequent chapters. Those chapters also define and use additional terms (as is the case, for example, with chapter XIV on the impact of insolvency on a security right). The definitions should be read together with the relevant recommendations. The principal terms are defined as follows:

(a) “Acknowledgement” with respect to a right to receive the proceeds under an independent undertaking means that the guarantor/issuer, confirmer or nominated person that will pay or otherwise give value upon a demand for payment (“draw”) under an independent undertaking has, unilaterally or by agreement:

(i) Acknowledged or consented to (however acknowledgement or consent is evidenced) the creation of a security right (whether denominated as an

assignment or otherwise) in favour of the secured creditor in the right to receive the proceeds under an independent undertaking; or

(ii) Has obligated itself to pay or give value to the secured creditor upon a draw under an independent undertaking;

(b) “Acquisition secured creditor” (a term used in the context of both the unitary and the non-unitary approaches to acquisition financing) means a secured creditor that has an acquisition security right. In the context of the unitary approach, the term includes a retention-of-title seller or financial lessor (terms used in the context of the non-unitary approach);

(c) “Acquisition security right” (a term used in the context of both the unitary and the non-unitary approaches to acquisition financing) means a security right in a tangible asset (other than a negotiable instrument or negotiable document) that secures the obligation to pay any unpaid portion of the purchase price of the asset or an obligation incurred or credit otherwise provided to enable the grantor to acquire the asset. An acquisition security right need not be denominated as such. Under the unitary approach, the term includes a right that is a retention-of-title right or a financial lease right (terms used in the context of the non-unitary approach);

(d) “Assignee” means the person to which an assignment of a receivable is made;¹

(e) “Assignment” means the creation of a security right in a receivable that secures the payment or other performance of an obligation. While an assignment that is an outright transfer does not secure the payment or other performance of an obligation, for convenience of reference, the term also includes an outright transfer of a receivable;²

(f) “Assignor” means the person that makes an assignment of a receivable;

(g) “Attachment to immovable property” means a tangible asset that is so physically attached to immovable property that, despite the fact that it has not lost its separate identity, is treated as immovable property under the law of the State where the immovable property is located;

(h) “Attachment to movable property” means a tangible asset that is physically attached to another tangible asset but has not lost its separate identity;

(i) “Bank account” means an account maintained by a bank to which funds may be credited. The term includes a checking or other current account, as well as a savings or time deposit account. The term does not include a right against the bank to payment evidenced by a negotiable instrument;

The term also includes a right to the payment of funds transferred to the bank by way of anticipatory reimbursement of a future payment obligation to which the bank has committed and a right to the payment of funds transferred to the bank by way of cash collateral securing an obligation owed to the bank to the extent that the transferor of those funds has a claim to them, if under national law the bank’s obligation is a bank account.

¹ For the definitions of the terms “assignee”, “assignor” and “assignment”, see article 2, subparagraph (a), of the United Nations Convention on the Assignment of Receivables in International Trade (United Nations publication, Sales No. E.04.V.14; hereinafter referred to as “the United Nations Assignment Convention”).

² See the definition of “security right”, as well as recommendation 3 and related commentary.

(j) “Competing claimant”³ means a creditor of a grantor competing with another creditor that has a security right in an encumbered asset of the grantor and includes:

- (i) Another secured creditor with a security right in the same encumbered asset (whether as an original encumbered asset or proceeds);
- (ii) In the context of the non-unitary approach to acquisition financing, the seller, financial lessor or other acquisition financier of the same encumbered asset that has retained title to it;
- (iii) Another creditor of the grantor that has a right in the same encumbered asset;
- (iv) The insolvency representative in the insolvency of the grantor;⁴ or
- (v) Any buyer or other transferee (including a lessee or licensee) of the encumbered asset;

(k) “Confirmer” means a bank or other person that adds its own independent undertaking to that of a guarantor/issuer;

In line with article 6, subparagraph (e), of the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit⁵ (hereinafter referred to as “the United Nations Guarantee and Stand-by Convention”), a confirmation provides the beneficiary with the option of demanding payment from the confirmer in conformity with the terms and conditions of the confirmed independent undertaking instead of from the guarantor/issuer;

(l) “Consumer goods” means goods that the grantor uses or intends to use for personal, family or household purposes;

(m) “Control” with respect to a right to receive the proceeds under an independent undertaking exists:

- (i) Automatically upon the creation of the security right if the guarantor/issuer, confirmer or nominated person is the secured creditor; or
- (ii) If the guarantor/issuer, confirmer or nominated person has made an acknowledgment in favour of the secured creditor;

(n) “Control” with respect to a right to payment of funds credited to a bank account exists:

- (i) Automatically upon the creation of a security right if the depositary bank is the secured creditor;
- (ii) If the depositary bank has concluded a control agreement with the grantor and the secured creditor evidenced by a signed writing⁶ according to

³ For the definition of the term “competing claimant”, see article 5, subparagraph (m), of the United Nations Assignment Convention.

⁴ In the chapter on insolvency, reference is made to “the insolvency of the debtor” for reasons of consistency with the terminology used in the UNCITRAL Legislative Guide on Insolvency Law (United Nations publication, Sales No. E.05.V.10; hereinafter referred to as “the UNCITRAL Insolvency Guide”).

⁵ United Nations publication, Sales No. E.97.V.12.

⁶ For the meaning of the term “signed writing” in the context of electronic communications, see recommendations 9 and 10.

which the depositary bank has agreed to follow instructions from the secured creditor with respect to the payment of funds credited to the bank account without further consent from the grantor; or

(iii) If the secured creditor is the account holder;

(o) “Debtor” means a person that owes performance of the secured obligation and includes a secondary obligor such as a guarantor of a secured obligation. The debtor may or may not be the person that creates the security right (see the definition of the term “grantor”);

(p) “Debtor of the receivable” means a person liable for payment of a receivable. “Debtor of the receivable” includes a guarantor or other person secondarily liable for payment of the receivable;⁷

A guarantor in an accessory guarantee is not only a debtor of the receivable of which it has guaranteed the payment, but also a debtor of the receivable constituted by the guarantee, as an accessory guarantee is itself a receivable (i.e. there are two receivables);

(q) “Encumbered asset” means a tangible or intangible asset that is subject to a security right. The term also includes a receivable that has been the subject of an outright transfer;⁸

(r) “Equipment” means a tangible asset used by a person in the operation of its business;

(s) “Financial contract” means any spot, forward, future, option or swap transaction involving interest rates, commodities, currencies, equities, bonds, indices or any other financial instrument, any repurchase or securities lending transaction, and any other transaction similar to any transaction referred to above entered into in financial markets and any combination of the transactions mentioned above;⁹

The reference in this definition to “any other transaction similar to any transaction referred to above entered into in financial markets” is intended to include the full range of transactions entered into in financial markets. The term is flexible. It includes any transaction entered into in financial markets under which payment rights are determined by reference to: (a) underlying asset classes; or (b) quantitative measures of economic or financial risk or value associated with an occurrence or contingency. Examples are transactions under which payment rights are determined by reference to weather statistics, freight rates, emissions allowances or economic statistics.

(t) “Financial lease right” (a term used only in the context of the non-unitary approach to acquisition financing) means a lessor’s right in a tangible asset (other than a negotiable instrument or negotiable document) that is the object of a lease agreement under which, at the end of the lease:

(i) The lessee automatically becomes the owner of the asset that is the object of the lease;

⁷ See article 2, subparagraph (a), of the United Nations Assignment Convention.

⁸ See the definition of “security right”, as well as recommendation 3 and related commentary.

⁹ See article 5, subparagraph (k), of the United Nations Assignment Convention; see also the relevant definition in the UNCITRAL Insolvency Guide.

(ii) The lessee may acquire ownership of the asset by paying no more than a nominal price; or

(iii) The asset has no more than a nominal residual value;

The term includes a hire-purchase agreement, even if not nominally referred to as a lease, provided that it meets the requirements of subparagraph (i), (ii) or (iii);

(u) “Grantor” means a person that creates a security right to secure either its own obligation or that of another person.¹⁰ Under the unitary approach to acquisition financing, the term “grantor” of an acquisition security right includes a retention-of-title buyer or financial lessee. While an assignor in an outright transfer of a receivable does not assign the receivable in order to secure the performance of an obligation, for convenience of reference, the term “grantor” also includes an assignor in an outright transfer of a receivable;¹¹

(v) “Guarantor/issuer” means a bank or other person that issues an independent undertaking;

(w) “Independent undertaking” means a letter of credit (commercial or standby), a confirmation of a letter of credit, an independent guarantee (including a demand- or first-demand-bank guarantee, or a counter-guarantee) or any other undertaking recognized as independent by law or practice rules such as the United Nations Guarantee and Stand-by Convention, the Uniform Customs and Practice for Documentary Credits, the Rules on International Standby Practices and the Uniform Rules for Demand Guarantees;

(x) “Insolvency court” means a judicial or other authority competent to control or supervise insolvency proceedings;

[Note to the Commission: As the term “insolvency court” is used only in the definition of “insolvency proceedings” and in the insolvency chapter, the Commission may wish to consider deleting the definition of “insolvency court” and including an explanation of its meaning in chapter XIV on the impact of insolvency on a security right.]

(y) “Insolvency estate” means the assets of the debtor subject to the insolvency proceedings;

(z) “Insolvency proceedings” means collective proceedings, subject to insolvency court supervision, either for reorganization or liquidation;

(aa) “Insolvency representative” means a person or body, including one appointed on an interim basis, authorized in insolvency proceedings to administer the reorganization or the liquidation of the insolvency estate;

(bb) “Intangible asset” means all forms of movable assets other than tangible assets and includes incorporeal rights, receivables and rights to the performance of obligations other than receivables;

(cc) “Intellectual property” means copyrights, trademarks, patents, service marks, trade secrets and designs and any other asset considered to be intellectual property under the domestic law of the enacting State or under an international agreement to which the enacting State is a party;

¹⁰ See the definition of the term “debtor”.

¹¹ See the definition of “security right”, as well as recommendation 3 and related commentary.

The definition of “intellectual property” is intended to ensure consistency of the Guide with intellectual property laws and treaties, while at the same time respecting the right of the legislator in a State enacting the recommendations of the Guide to align the definition with its own law and international obligations.

An enacting State may add to this list or subtract from it types of intellectual property to conform it to national law. The reference to international agreements is intended to refer to agreements, such as the Convention Establishing the World Intellectual Property Organization and the Agreement on Trade-Related Aspects of Intellectual Property Rights (“TRIPS”).

In order to clarify that these definitions and the recommendations referring to them apply only to tangible assets (and not to intangible assets such as intellectual property), reference is made in the definitions of the terms “acquisition security right”, “acquisition financing right”, “retention-of-title right” and “financial lease” to “tangible assets”.

In the definition of the term “receivable”, reference to “the performance of non-monetary obligations” has been deleted to clarify the understanding that the definition and the recommendations relating to receivables apply only to receivables and not, for example, to the rights of a licensee or the obligations of a licensor under a contractual license of intellectual property.

(dd) “Inventory” means tangible assets held for sale or lease in the ordinary course of the grantor’s business, as well as raw and semi-processed materials (work-in-process);

(ee) “Issuer” of a negotiable document means the person that is obligated to deliver the tangible assets covered by the document under the law governing negotiable documents, whether that person performs all obligations or not;

(ff) “Knowledge” means actual rather than constructive knowledge;

(gg) “Mass or product” means tangible assets other than money that are so physically associated or united with other tangible assets that they have lost their separate identity;

(hh) “Money” means currency currently authorized as legal tender by any State. It does not include funds credited to a bank account or negotiable instruments such as cheques;

(ii) “Negotiable document” means a document, such as a warehouse receipt or a bill of lading, that embodies a right to delivery of tangible assets and satisfies the requirements for negotiability under the law governing negotiable documents;

(jj) “Negotiable instrument” means an instrument, such as a cheque, bill of exchange or promissory note, that embodies a right to payment and satisfies the requirements for negotiability under the law governing negotiable instruments;

[Note to the Commission: The Commission may wish to consider that a note should be inserted after the definitions of “negotiable instrument” and “negotiable document” along the following lines:

“The Guide was prepared against the background of negotiable instruments and negotiable documents in paper form, in view of the particular difficulty of creating an electronic equivalent of paper-based negotiability. However, the Guide should not be interpreted as discouraging the use of

electronic equivalents of paper negotiable instruments or negotiable documents. Thus, an enacting State that wishes to address this matter will need to devise special rules (the United Nations Convention on the Use of Electronic Communications in International Contracts does not address the electronic equivalent of paper-based negotiability for the same reason)."^{12]}

(kk) "Netting agreement" means an agreement between two or more parties that provides for one or more of the following:

(i) The net settlement of payments due in the same currency on the same date whether by novation or otherwise;

(ii) Upon the insolvency or other default by a party, the termination of all outstanding transactions at their replacement or fair market values, conversion of such sums into a single currency and netting into a single payment by one party to the other; or

(iii) The set-off of amounts calculated as set forth in subparagraph (ii) of this definition under two or more netting agreements;¹³

(ll) "Nominated person" means a bank or other person that is identified in an independent undertaking by name or type (e.g. "any bank in country X") as being nominated to give value under an independent undertaking and that acts pursuant to that nomination and, in the case of a freely available independent undertaking, any bank or other person;

(mm) "Notice" means a communication in writing;¹⁴

[*Note to the Commission: The Commission may wish to consider adding to this definition wording along the following lines:*

"A person "notifies", "sends a notice" or "gives a notice" to another person by taking reasonable steps to inform the other person, whether or not the other person is actually so informed." The suggested text would explain the meaning of references in the Guide to "notifying", "sending" or "giving" "notices".]

(nn) "Notification of the assignment" means a communication in writing that reasonably identifies the assigned receivable and the assignee;¹⁵

(oo) "Original contract" means, in the context of a receivable created by contract, the contract between the assignor and the debtor of the receivable from which the receivable arises;

(pp) "Possession" (except as the term is used in recommendations 28 and 51-53 with respect to the issuer of a negotiable document) means the actual possession only of a tangible asset by a person or an agent or employee of that person, or by an independent person that acknowledges that it holds for that person. It does not include non-actual possession described by terms such as constructive, fictive, deemed or symbolic possession;

¹² See United Nations publication, Sales No. E.07.V.2, explanatory note, para. 7.

¹³ See article 5, subparagraph (l), of the United Nations Assignment Convention.

¹⁴ For the electronic equivalents of the terms "writing" and "signed writing", see recommendations 9 and 10.

¹⁵ As to when notification of the assignment is effective, see recommendation 115.

(qq) “Priority” means the right of a person to derive the economic benefit of its security right in preference to a competing claimant;

(rr) “Proceeds” means whatever is received in respect of encumbered assets, including what is received as a result of sale or other disposition or collection, lease or licence of an encumbered asset, proceeds of proceeds, civil and natural fruits, dividends, distributions, insurance proceeds and claims arising from defects in, damage to or loss of an encumbered asset;¹⁶

(ss) “Receivable” means a right to payment of a monetary obligation excluding a right to payment evidenced by a negotiable instrument, a right to receive the proceeds under an independent undertaking and a right to payment of funds credited to a bank account;¹⁷

(tt) “Retention-of-title right” (a term used only in the context of the non-unitary approach to acquisition financing) means a seller’s right in a tangible asset (other than a negotiable instrument or a negotiable document) pursuant to an arrangement with the buyer by which ownership of the asset is not transferred (or is not transferred irrevocably) from the seller to the buyer until the unpaid portion of the purchase price is paid;

(uu) “Right to receive the proceeds under an independent undertaking” means the right to receive a payment due, a draft accepted or deferred payment incurred or another item of value, in each case to be paid or delivered by the guarantor/issuer, confirmer or nominated person giving value for a draw under an independent undertaking. The term also includes the right to receive payment in connection with the purchase by a negotiating bank of a negotiable instrument or a document under a complying presentation. The term does not include:

- (i) The right to draw under an independent undertaking; and
- (ii) What is received upon honour of an independent undertaking;

A security right in the right to receive the proceeds under an independent undertaking (as an original encumbered asset) is different from a security right in “proceeds” (a key concept of the Guide) of assets covered in the Guide (see definition of the term “proceeds” and recommendation 19). Thus, what is received as a result of a complying presentation under an independent undertaking constitutes the “proceeds” of the right to receive the proceeds under an independent undertaking.

(vv) “Secured creditor” means a creditor that has a security right. While an outright transfer of a receivable does not secure the performance of an obligation, for convenience of reference, the term also includes the assignee in an outright transfer of a receivable;¹⁸

(ww) “Secured obligation” means an obligation secured by a security right;

(xx) “Secured transaction” means a transaction that creates a security right. While an outright transfer of a receivable does not secure the performance of an

¹⁶ See article 5, subparagraph (j), of the United Nations Assignment Convention.

¹⁷ For the definition of the term “receivable”, see article 2, subparagraph (a), of the United Nations Assignment Convention; for the exclusions of bank deposits, letters of credit and negotiable instruments, see article 4, subparagraphs 2 (f) and 2 (g), and paragraph 3, respectively, of the United Nations Assignment Convention.

¹⁸ See the definition of “security right”, as well as recommendation 3 and related commentary.

obligation, for convenience of reference, the term also includes an outright transfer of a receivable;¹⁹

(yy) “Security agreement” means an agreement, in whatever form or terminology, between a grantor and a creditor that creates a security right. While an outright transfer of a receivable does not secure the performance of an obligation, for convenience of reference, the term also includes an agreement for the outright transfer of a receivable;²⁰

(zz) “Security right” means a property right in a movable asset that is created by agreement and secures payment or other performance of an obligation, regardless of whether the parties have denominated it as a security right. In the context of the unitary approach to acquisition financing, the term includes both acquisition security rights and non-acquisition security rights. In the context of the non-unitary approach to acquisition financing, it does not include a retention-of-title or financial lease right. While an outright transfer of a receivable does not secure payment or other performance of an obligation, for convenience of reference, the term “security right” also includes the right of the assignee in an outright transfer of a receivable.²¹ The term does not include a personal right against a guarantor or other person liable for the payment of the secured obligation;

(aaa) “Subsequent assignment” means an assignment by the initial or any other assignee.²² In the case of a subsequent assignment, the person that makes that assignment is the assignor and the person to which that assignment is made is the assignee; and

(bbb) “Tangible asset” means every form of corporeal movable asset. Among the categories of tangible asset are inventory, equipment, consumer goods, attachments, negotiable instruments, negotiable documents and money.

I. Key objectives of an effective and efficient secured transactions law*

1. In order to provide a broad policy framework for an effective and efficient secured transactions law (the “secured transactions law” is hereinafter referred to as “the law” or “this law”), the law should be designed:

- (a) To promote secured credit;
- (b) To allow utilization of the full value inherent in a broad range of assets to support credit in the widest possible array of secured transactions;
- (c) To enable parties to obtain security rights in a simple and efficient manner;
- (d) To provide for equal treatment of diverse sources of credit and of diverse forms of secured transactions;

¹⁹ Ibid.

²⁰ Ibid.

²¹ Ibid.

²² See article 2, subparagraph (b), of the United Nations Assignment Convention.

* The key objectives could be included in a preamble or other statement accompanying the secured transactions law as a guide to the underlying legislative policies to be taken into account in the interpretation and application of the secured transactions law.

- (e) To validate security rights in assets that remain in the possession of the grantor;
- (f) To enhance predictability and transparency with respect to rights serving security purposes by providing for registration of a notice in a general security rights registry;
- (g) To establish clear and predictable priority rules;
- (h) To facilitate enforcement of creditor's rights in a predictable and efficient manner;
- (i) To balance the interests of affected persons;
- (j) To recognize party autonomy; and
- (k) To harmonize secured transactions laws, including conflict-of-laws rules.

II. Scope of application and other general rules

Purpose

The purpose of provisions on the scope of application of the law is to establish a single comprehensive regime for secured transactions. The provisions specify the security rights and other rights to which the law applies.

Scope of application

2. Subject to recommendations 3-7,²³ the law should apply to all rights in movable assets created by agreement that secure payment or other performance of an obligation, regardless of the form of the transaction, the type of the movable asset, the status of the grantor or secured creditor or the nature of the secured obligation. Thus, the law should apply to:

- (a) Security rights in all types of movable asset, tangible or intangible, present or future, including inventory, equipment and other tangible assets, contractual and non-contractual receivables, contractual non-monetary claims, negotiable instruments, negotiable documents, rights to payment of funds credited to a bank account, rights to receive the proceeds under an independent undertaking, and intellectual property;
- (b) Security rights created or acquired by all legal and natural persons, including consumers, without, however, affecting rights under consumer-protection legislation;
- (c) Security rights securing all types of obligation, present or future, determined or determinable, including fluctuating obligations and obligations described in a generic way; and
- (d) All property rights created contractually to secure the payment or other performance of an obligation, including transfers of title to tangible assets for

²³ Where reference is made in a recommendation to recommendations in another chapter, the number and subject of the chapter in which those recommendations are included, are also referred to. Where no such reference is made, the recommendations referred to are in the same chapter as the recommendation that contains the reference.

security purposes or assignments of receivables for security purposes, the various forms of retention-of-title sales and financial leases.

The law should also apply to security rights in proceeds of encumbered assets.

Outright transfers of receivables

3. The law should apply to outright transfers of receivables despite the fact that such transfers do not secure the payment or other performance of an obligation. This recommendation is subject to the exception provided in recommendation 164 (chapter X on the enforcement of a security right).

[Note to the Commission: The Commission may wish to note that, in line with the approach taken in the United Nations Assignment Convention, the Guide recommends that its recommendations (with the exception of certain recommendations on enforcement) apply to all assignments of receivables (including outright transfers of receivables). The commentary will explain the reasons for this approach and discuss in particular the practical need to have the recommendations on creation, third-party effectiveness and priority apply to all assignments of receivables.]

The commentary will also explain that, although the Guide applies to security rights in as well as to outright transfers of receivables in the same way that it applies to security rights and uses common terminology to describe both types of right, it does not transform outright transfers into security rights. Such a result (sometimes referred to as “re-characterization”) would be undesirable and indeed harmful for important practices such as securitization of receivables (which, even when it involves a true sale, is generally subject to the regime applicable to secured transactions).

As provided in the definitions, with respect to receivables only, and as a matter of expression and for convenience of drafting only, references in the law to security rights are also references to the rights of an outright transferee of receivables, references to a secured creditor are also references to an outright transferee, references to a grantor are also references to an outright transferor and references to an encumbered asset are also references to a receivable that has been transferred outright.

The commentary will also explain that the Guide’s coverage of outright transfers of receivables in addition to secured transactions, in no way obviates the distinction between an outright transfer of receivables and a transfer of a right in receivables as security for an obligation. By way of contrast, the Guide does make irrelevant any distinctions in form or terminology between transactions that secure payment or other performance of an obligation. Thus, for example, the creation of a right in a movable asset to secure payment or performance of an obligation is within the scope of the Guide whether the right is created by a transaction denominated as a transfer of the asset for security purposes (also sometimes known as a fiduciary transfer) or one that is denominated as a pledge.]

Limitations on scope

4. Notwithstanding recommendation 2, the law should not apply to:

(a) Aircraft, railway rolling stock, space objects, ships as well as other categories of mobile equipment, in so far as such asset is covered by a national law

or an international agreement to which the State enacting legislation based on these recommendations (herein referred to as “the State” or “this State”) is a party and the matters covered by this law are addressed in that national law or international agreement;

(b) Intellectual property in so far as the provisions of the law are inconsistent with national law or international agreements, to which the State is a party, relating to intellectual property;

(c) Securities;

(d) Payment rights arising under or from financial contracts governed by netting agreements, except a receivable owed on the termination of all outstanding transactions; and

(e) Payment rights arising under or from foreign exchange transactions.

5. The law should not apply to immovable property except as provided in recommendations 25 and 48 (chapter IV on the creation of a security right).

6. The law should provide that if, under other law, a security right in an excluded type of asset (e.g. immovable property) extends to a type of proceeds to which this law applies (e.g. receivables), this law applies to the security right in the proceeds except to the extent that that other law applies to that security right.

7. The law should not include any other limitations to its scope of application. To the extent any other limitations are introduced, they should be set out in the law in a clear and specific way.

[Note to the Commission: The Commission may wish to note that a previous version of this recommendation referred to employment benefits (see A/CN.9/WG.VI/WP.29). It was reformulated to avoid encouraging a State to further limit the scope of application of the law, and to ensure that any further limitation is set out in the law in a clear and transparent way. The Commission may wish to consider whether the policy in this recommendation is more appropriately reflected in the commentary.]

Party autonomy

8. The law should provide that, except as otherwise provided in recommendations 15 (chapter IV on the creation of a security right), 108-109 (chapter VIII on the rights and obligations of the parties), 129-133 (chapter X on the enforcement of a security right), 174-183 (chapter XI, unitary approach to acquisition financing), 184-199 (chapter XI, non-unitary approach to acquisition financing), 200-212 and 214-224 (chapter XII on conflict of laws) the secured creditor and the grantor or the debtor may derogate from or vary by agreement its provisions relating to their respective rights and obligations. Such an agreement does not affect the rights of any person that is not a party to the agreement.²⁴

Electronic communications

9. The law should provide that, where it requires that a communication or a contract should be in writing, or provides consequences for the absence of a writing,

²⁴ See article 6 of the United Nations Assignment Convention.

that requirement is met by an electronic communication if the information contained therein is accessible so as to be usable for subsequent reference.

10. The law should provide that, where the law requires that a communication or a contract should be signed by a person, or provides consequences for the absence of a signature, that requirement is met in relation to an electronic communication if:

(a) A method is used to identify the party and to indicate that person's intention in respect of the information contained in the electronic communication; and

(b) The method used is either:

(i) As reliable as appropriate for the purpose for which the electronic communication was generated or communicated, in the light of all the circumstances, including any relevant agreement; or

(ii) Proven in fact to have fulfilled the functions described in subparagraph (a) above, by itself or together with further evidence.²⁵

III. Basic approaches to security

Purpose

The purpose of provisions on basic approaches to security is to ensure that the law:

(a) Applies to all contractually created rights in movable assets that secure the payment or other performance of an obligation ("functional approach"); and

(b) Provides for the appropriate implementation of the functional approach so as to ensure that all providers of financing are treated according to rules that produce functionally equivalent outcomes.

Functional approach

11. The law should adopt a functional approach, under which it covers all rights in movable assets that are created by agreement and secure the payment or other performance of an obligation, regardless of the form of the transaction or the terminology used by the parties (including rights of transferees under a transfer of title to tangible assets for security purposes, rights of an assignee under an assignment of receivables for security purposes, as well as rights of sellers or financial lessors under various forms of retention-of-title and financial leases, respectively). Except with respect to acquisition financing, the functional approach should be implemented in a way that classifies all rights securing the performance of an obligation as security rights and subjects them to a common set of rules.

12. With respect to acquisition financing, the functional approach may be implemented either:

(a) In a way that classifies as acquisition security rights all rights in movable assets that secure the payment or other performance of an obligation, and that makes

²⁵ For recommendations 9 and 10, see article 9, paragraphs 2 and 3, of the United Nations Convention on the Use of Electronic Communications in International Contracts.

them subject to a common set of rules (“the unitary approach to acquisition financing” or “the unitary approach”); or

(b) In a way that classifies:

(i) As acquisition security rights all rights in movable assets that secure the payment or other performance of an obligation, other than the rights of a seller under a retention-of-title agreement and of a lessor under a financial lease;

(ii) As ownership rights the rights of a seller under a retention-of-title agreement and of a lessor under a financial lease, but makes those ownership rights subject to rules that produce outcomes that are the functional equivalent of the outcomes produced with respect to acquisition security rights, thereby ensuring that all providers of acquisition financing are treated equally (the approach in subparagraph (b) of this recommendation is referred to as “the non-unitary approach to acquisition financing” or “the non-unitary approach”).

[Note to the Commission: The Commission may wish to note that this recommendation has been redrafted to reflect the Commission’s understanding with respect to the functional approach and the way it is to be implemented with respect to acquisition security rights (in a unitary or a non-unitary way; see chapter XI on acquisition financing).]

IV. Creation of a security right (effectiveness as between the parties)

Purpose

The purpose of provisions on the creation of a security right is to specify the requirements that must be satisfied in order for a security right to be effective between the parties.

A. General recommendations*

Creation of a security right

13. The law should provide that a security right in an asset is created by an agreement concluded between the grantor and the secured creditor. In the case of an asset with respect to which the grantor has rights or the power to encumber at the time of the conclusion of the agreement, the security right in that asset is created at that time. In the case of an asset with respect to which the grantor acquires rights or the power to encumber thereafter, the security right in that asset is created when the grantor acquires rights in the asset or the power to encumber the asset.

* The general recommendations apply to security rights in all types of asset covered in the Guide, as modified by the asset-specific recommendations.

Minimum content of a security agreement

14. The law should provide that a security agreement must:

- (a) Reflect the intent of the parties to create a security right;
- (b) Identify the secured creditor and the grantor;
- (c) Describe the secured obligation; and
- (d) Describe the encumbered assets in a manner that reasonably allows their identification.

[Note to the Commission: The Commission may wish to note that the commentary will explain that the description need not be specific. A general description by category, type or class of asset is sufficient (e.g. “desk”, “furniture”, “office furniture” or “equipment”, “all present and future assets” or “all present and future inventory”).

The Commission may wish to note that recommendation 57, subparagraph (a), for confidentiality reasons, permits the secured creditor to avoid disclosing its name on the notice to be registered. The Commission may wish to consider whether, for the same or other reasons, it would be sufficient for the security agreement to identify a representative of the secured creditor rather than the secured creditor itself.]

Form of the security agreement

15. The law should provide that a security agreement may be oral if accompanied by the secured creditor’s possession of the encumbered asset. Otherwise, the agreement must be concluded in or evidenced by a writing that, in conjunction with the course of conduct between the parties, indicates the grantor’s intent to create a security right.

Obligations secured by a security right

16. The law should provide that a security right may secure any type of obligation, whether present or future, determined or determinable, conditional or unconditional, fixed or fluctuating.

Assets subject to a security right

17. The law should provide that a security right may encumber any type of asset, including parts of assets and undivided rights in assets. A security right may encumber assets that, at the time the security agreement is concluded, may not yet exist or that the grantor may not yet own or have the power to encumber. It may also encumber all assets of a grantor. Any exceptions to these rules should be limited and described in the law in a clear and specific way.

18. The law should provide that, except as provided in recommendations 23-25, it does not override provisions of any other law to the extent that they limit the creation or enforcement of a security right in, or the transferability of, specific types of asset.

Continuation of a security right in proceeds

19. The law should provide that, unless otherwise agreed by the parties to a security agreement, a security right in an encumbered asset extends to its identifiable proceeds (including proceeds of proceeds).

Commingled proceeds

20. The law should provide that, where proceeds in the form of money or funds credited to a bank account have been commingled with other assets of the same kind so that the proceeds are no longer identifiable, the amount of the proceeds immediately before they were commingled is to be treated as identifiable proceeds after commingling. However, if, at any time after commingling, the total amount of the asset is less than the amount of the proceeds, the total amount of the asset at the time that its amount is lowest plus the amount of any proceeds later commingled with the asset is to be treated as identifiable proceeds.

Creation and continuation of a security right in an attachment

21. The law should provide that a security right may be created in a tangible asset that is an attachment at the time of creation of the security right or continues in a tangible asset that becomes an attachment subsequently. A security right in an attachment to immovable property may be created under this law or under the law governing immovable property.

Continuation of a security right into a mass or product

22. The law should provide that a security right created in tangible assets before they are commingled in a mass or product continues in the mass or product. The security right that continues in the mass or product is limited to the value of the assets immediately before they became part of the mass or product.

B. Asset-specific recommendations**Effectiveness of a bulk assignment of receivables and an assignment of future, parts of and undivided interests in receivables**

23. The law should provide that:

(a) An assignment of contractual receivables that are not specifically identified, future receivables and parts of or undivided interests in receivables is effective as between the assignor and the assignee and as against the debtor of the receivable, as long as, at the time of the assignment or, in the case of future receivables, at the time they arise, they can be identified to the assignment to which they relate; and

(b) Unless otherwise agreed, an assignment of one or more future receivables is effective without a new act of transfer being required to assign each receivable.²⁶

²⁶ For recommendations 23-25, see articles 8-10 of the United Nations Assignment Convention.

Effectiveness of an assignment of receivables made despite an anti-assignment clause

24. The law should provide that:

(a) An assignment of a receivable is effective as between the assignor and the assignee and as against the debtor of the receivable notwithstanding an agreement between the initial or any subsequent assignor and the debtor of the receivable or any subsequent assignee limiting in any way the assignor's right to assign its receivables;

(b) Nothing in this recommendation affects any obligation or liability of the assignor for breach of the agreement mentioned in subparagraph (a) of this recommendation, but the other party to such an agreement may not avoid the original contract or the assignment contract on the sole ground of that breach. A person that is not a party to such an agreement is not liable on the sole ground that it had knowledge of the agreement;

(c) This recommendation applies only to assignments of receivables:

(i) Arising from an original contract that is a contract for the supply or lease of goods or services other than financial services, a construction contract or a contract for the sale or lease of immovable property;

(ii) Arising from an original contract for the sale, lease or licence of industrial or other intellectual property or of proprietary information;

(iii) Representing the payment obligation for a credit card transaction; or

(iv) Owed to the assignor upon net settlement of payments due pursuant to a netting agreement involving more than two parties.

Creation of a security right in a personal or property right securing a receivable, a negotiable instrument or any other intangible asset

25. The law should provide that:

(a) A secured creditor with a security right in a receivable, negotiable instrument or any other intangible asset covered by this law has the benefit of any personal or property right that secures payment or other performance of the receivable, negotiable instrument or intangible asset automatically, without further action by either the grantor or the secured creditor;

(b) If the personal or property right is an independent undertaking, the security right automatically extends to the right to receive the proceeds under the independent undertaking but does not extend to the right to draw under the independent undertaking;

(c) This recommendation does not affect a right in immovable property that under other law is transferable separately from a receivable, negotiable instrument or other intangible asset that it may secure;

(d) A secured creditor with a security right in a receivable, negotiable instrument or any other intangible asset covered by this law has the benefit of any personal or property right securing payment or other performance of the receivable, negotiable instrument or other intangible asset notwithstanding any agreement between the grantor and the debtor of the receivable or the obligor of the negotiable instrument or other intangible asset limiting in any way the grantor's right to create

a security right in the receivable, negotiable instrument or other intangible asset, or in any personal or property right securing payment or other performance of the receivable, negotiable instrument or other intangible asset;

(e) Nothing in this recommendation affects any obligation or liability of the grantor for breach of the agreement mentioned in subparagraph (d) of this recommendation, but the other party to such an agreement may not avoid the contract from which the receivable, negotiable instrument or other intangible asset arises, or the security agreement creating the personal or property security right on the sole ground of that breach. A person that is not a party to such an agreement is not liable on the sole ground that it had knowledge of the agreement;

(f) Subparagraphs (d) and (e) of this recommendation apply only to security rights in receivables, negotiable instruments or other intangible assets:

(i) Arising from an original contract that is a contract for the supply or lease of goods or services other than financial services, a construction contract or a contract for the sale or lease of immovable property;

(ii) Arising from an original contract for the sale, lease or licence of industrial or other intellectual property or of proprietary information;

(iii) Representing the payment obligation for a credit card transaction; or

(iv) Owed to the assignor upon net settlement of payments due pursuant to a netting agreement involving more than two parties;

(g) Subparagraph (a) of this recommendation does not affect any duties of the grantor to the debtor of the receivable or to the obligor of the negotiable instrument or other intangible asset; and

(h) To the extent that the automatic effects under subparagraph (a) of this recommendation and recommendation 50 are not impaired, this recommendation does not affect any requirement under other law relating to the form or registration of the creation of a security right in any asset, securing payment or other performance of a receivable, negotiable instrument or other intangible asset that is not covered by this law.

Creation of a security right in a right to payment of funds credited to a bank account

26. The law should provide that a security right in a right to payment of funds credited to a bank account is effective notwithstanding an agreement between the grantor and the depositary bank limiting in any way the grantor's right to create such a security right. However, the depositary bank has no duty to recognize the secured creditor and no obligation is otherwise imposed on the depositary bank with respect to the security right without the depositary bank's consent (for the depositary bank's rights and obligations, see recommendations 122 and 123; chapter IX on the rights and obligations of third-party obligors).

Creation of a security right in a right to receive the proceeds under an independent undertaking

27. The law should provide that a beneficiary of an independent undertaking may create a security right in a right to receive the proceeds under an independent undertaking, even if the right to draw under the independent undertaking is itself not

transferable under the law and practice governing independent undertakings. The creation of a security right in a right to receive the proceeds under an independent undertaking is not a transfer of the right to draw under an independent undertaking.

Extension of a security right in a negotiable document to the tangible assets covered by the negotiable document

28. The law should provide that a security right in a negotiable document extends to the tangible assets covered by the document, provided that the issuer is in possession of the assets, directly or indirectly, at the time the security right in the document is created.

V. Effectiveness of a security right against third parties

Purpose

The purpose of provisions on the effectiveness of a security right against third parties is to create a foundation for the predictable, fair and efficient ordering of priority by:

(a) Requiring registration as a precondition for the effectiveness of a security right against third parties, except where exceptions and alternatives to registration are appropriate in light of countervailing commercial policy considerations; and

(b) Establishing a legal framework to create and support a simple, cost-efficient and effective public registry system for the registration of notices with respect to security rights.

A. General recommendations

Achieving third-party effectiveness

29. The law should provide that a security right is effective against third parties only if it is created and one of the methods for achieving third-party effectiveness referred to in recommendation 32, 34 or 35 has been followed.

Effectiveness against the grantor of a security right that is not effective against third parties

30. The law should provide that a security right that has been created is effective between the grantor and the secured creditor even if it is not effective against third parties.

Continued third-party effectiveness after a transfer of the encumbered asset

31. The law should provide that, after transfer of a right other than a security right in an encumbered asset, a security right in the encumbered asset that is effective against third parties at the time of the transfer continues to encumber the asset except as provided in recommendations 76-78 (chapter VII on the priority of a

security right), and remains effective against third parties except as provided in recommendation 62.

[Note to the Commission: The Commission may wish to note that recommendations 32-36 are not intended to state the relevant rules but rather to list, for the ease of the reader, the various methods for achieving third-party effectiveness and to refer to the following recommendations that state the relevant rules.]

General method for achieving third-party effectiveness: registration

32. The law should provide that a security right is effective against third parties if a notice with respect to the security right is registered in the general security rights registry referred to in recommendations 54-72 (chapter VI on the registry system).

33. The law should provide that registration of a notice does not create a security right and is not necessary for the creation of a security right.

Alternatives and exceptions to registration for achieving third-party effectiveness

34. The law should provide that:

(a) A security right may also be made effective against third parties by one of the following alternative methods:

(i) In tangible assets, by the secured creditor's possession, as provided in recommendation 37;

(ii) In tangible assets covered by a negotiable document, by the secured creditor's possession of the document, as provided in recommendations 51-53;

(iii) In movable assets subject to registration in a specialized registry or notation on a title certificate, by such registration or notation, as provided in recommendation 38;

(iv) In a right to payment of funds credited to a bank account, by control, as provided in recommendation 49; and

(v) In an attachment to immovable property, by registration in the immovable property registry, as provided in recommendation 43;

(b) A security right is effective against third parties automatically:

(i) In proceeds, if the security right in the original encumbered asset is effective against third parties, as provided in recommendations 39 and 40;

(ii) In an attachment to movable property, if the security right in the asset that becomes an attachment was effective against third parties before it became an attachment, as provided in recommendation 42;

(iii) In a mass or product, if the security right in processed or commingled assets was effective against third parties before they became part of the mass or product, as provided in recommendation 44; and

(iv) In movable assets, upon a change in the location of the asset or the grantor to this State, as provided in recommendation 45; and

(c) A security right in a personal or property right securing payment or other performance of a receivable, negotiable instrument or other intangible asset is effective against third parties, as provided in recommendation 48.

Method for achieving third-party effectiveness of a security right in a right to receive the proceeds under an independent undertaking

35. The law should provide that, except as provided in recommendation 48, a security right in a right to receive the proceeds under an independent undertaking may be made effective against third parties only by control, as provided in recommendation 50.

Different third-party effectiveness methods for different types of asset

36. The law should provide that different methods for achieving third-party effectiveness may be used for different types of encumbered asset, whether they are encumbered pursuant to the same security agreement or not.

Third-party effectiveness of a security right in tangible assets by possession

37. The law should provide that a security right in tangible assets may be made effective against third parties by registration as provided in recommendation 32 or by the secured creditor's possession.

Third-party effectiveness of a security right in movable assets subject to a specialized registration or a title certificate system

38. The law should provide that a security right in movable assets that is subject to registration in a specialized registry or notation on a title certificate under other law may be made effective against third parties by registration as provided in recommendation 32 or by:

- (a) Registration in the specialized registry; or
- (b) Notation on the title certificate.

Automatic third-party effectiveness of a security right in proceeds

39. The law should provide that, if a security right in an encumbered asset is effective against third parties, a security right in any proceeds of the encumbered asset (including any proceeds of proceeds) is effective against third parties when the proceeds arise, provided that the proceeds are described in a generic way in a registered notice or that the proceeds consist of money, receivables, negotiable instruments or rights to payment of funds credited to a bank account.

40. If the proceeds are not described in the registered notice or do not consist of the types of asset referred to in recommendation 39, the security right in the proceeds is effective against third parties for [a short period of time to be specified] days after the proceeds arise and continuously thereafter, if it was made effective against third parties by one of the methods referred to in recommendation 32 or 34 before the expiry of that time period.

Automatic third-party effectiveness of a security right in an attachment

41. The law should provide that, if a security right in a tangible asset is effective against third parties at the time when the asset becomes an attachment, the security right remains effective against third parties thereafter.

Third-party effectiveness of a security right in an attachment subject to a specialized registration or a title certificate system

42. The law should provide that a security right in an attachment to movable property that is subject to registration in a specialized registry or notation on a title certificate under other law may be made effective against third parties automatically as provided in recommendation 41 or by:

- (a) Registration in the specialized registry; or
- (b) Notation on the title certificate.

43. The law should provide that a security right in an attachment to immovable property may be made effective against third parties automatically as provided in recommendation 41 or by registration in the immovable property registry.

Automatic third-party effectiveness of a security right in a mass or product

44. The law should provide that, if a security right in a tangible asset is effective against third parties when it becomes part of a mass or product, the security right that continues in the mass or product, as provided in recommendation 22 (chapter IV on the creation of a security right), is effective against third parties.

Continuity in third-party effectiveness upon change of location to this State

45. The law should provide that, if a security right in an encumbered asset is effective against third parties under the law of the State in which the encumbered asset or the grantor is located (whichever determines the applicable law under the conflict-of-laws provisions), and that location changes to this State, the security right continues to be effective against third parties under the law of this State for [a short period of time to be specified] days after the change. If the requirements of the law of this State to make the security right effective against third parties are satisfied prior to the end of that period, the security right continues to be effective against third parties thereafter under the law of this State. For the purposes of any rule of this State in which time of registration or other method of achieving third-party effectiveness is relevant for determining priority, that time is the time when registration or third-party effectiveness was achieved under the law of the State in which the encumbered assets or the grantor were located before their location changed to this State.

Continuity in third-party effectiveness of a security right upon change of method of third-party effectiveness

46. The law should provide that third-party effectiveness of a security right is continuous notwithstanding a change in the method by which it is made effective against third parties, provided that there is no time when the security right is not effective against third parties.

Lapse in third-party effectiveness or advance registration

47. The law should provide that, if a security right has been made effective against third parties and subsequently there is a period during which the security right is not effective against third parties, third-party effectiveness may be re-established. In such a case, third-party effectiveness takes effect from the time it is re-established. Similarly, if registration made before creation of a security right as provided in recommendation 64 expires as provided in recommendation 66 (chapter VI on the registry system), it may be re-established. In such a case, registration takes effect from the time when the new notice with respect to the security right is registered.

B. Asset-specific recommendations**Third-party effectiveness of a security right in a personal or property right securing payment of a receivable, negotiable instrument or any other intangible asset**

48. The law should provide that, if a security right in a receivable, negotiable instrument or any other intangible asset covered by this law is effective against third parties, such third-party effectiveness extends to any personal or property right that secures payment or other performance of the receivable, negotiable instrument or other intangible asset, without further action by either the grantor or the secured creditor. If the personal or property right is an independent undertaking, its third-party effectiveness automatically extends to the right to receive the proceeds under the independent undertaking (but, as provided in recommendation 25, subparagraph (b), of chapter IV on the creation of a security right, the security right does not extend to the right to draw under the independent undertaking). This recommendation does not affect a right in immovable property that under other law is transferable separately from a receivable, negotiable instrument or other intangible asset that it may secure.

Third-party effectiveness of a security right in a right to payment of funds credited to a bank account

49. The law should provide that a security right in a right to payment of funds credited to a bank account may be made effective against third parties by registration as provided in recommendation 32 or by the secured creditor obtaining control with respect to the right to payment of funds credited to the bank account.

Third-party effectiveness of a security right in a right to receive the proceeds under an independent undertaking

50. The law should provide that, except as provided in recommendation 48, a security right in a right to receive the proceeds under an independent undertaking may be made effective against third parties only by the secured creditor obtaining control with respect to the right to receive the proceeds under the independent undertaking.

Third-party effectiveness of a security right in a negotiable document or assets covered by a negotiable document

51. The law should provide that a security right in a negotiable document may be made effective against third parties by registration as provided in recommendation 32 or by the secured creditor's possession of the document.

52. The law should provide that, if a security right in a negotiable document is effective against third parties, the corresponding security right in the assets covered by the document is also effective against third parties. During the period when a negotiable document covers assets, a security right in the assets may be made effective against third parties by the secured creditor's possession of the document.

53. The law should provide that a security right in a negotiable document that was made effective against third parties by the secured creditor's possession of the document remains effective against third parties for [a short period of time to be specified] days after the negotiable document has been relinquished to the grantor or other person for the purpose of ultimate sale or exchange, loading or unloading, or otherwise dealing with the assets covered by the negotiable document.

VI. The registry system**Purpose**

The purpose of provisions on the registry system is to establish a general security rights registry and to regulate its operation. The purpose of the registry system is to provide:

- (a) A method by which an existing or future security right in a grantor's existing or future assets may be made effective against third parties;
- (b) An efficient point of reference for priority rules based on the time of registration of a notice with respect to a security right; and
- (c) An objective source of information for third parties dealing with a grantor's assets (such as prospective secured creditors and buyers, judgement creditors and the grantor's insolvency representative) as to whether the assets may be encumbered by a security right.

To achieve this purpose, the registry system should be designed to ensure that the registration and searching processes are simple, time- and cost-efficient, user-friendly and publicly accessible.

Operational framework of the registration and searching processes

54. The law should ensure that:

- (a) Clear and concise guides to registration and searching procedures are widely available and information about the existence and role of the registry is widely disseminated;
- (b) Registration is effected by registering a notice that provides the information specified in recommendation 57, as opposed to requiring the submission of the original or a copy of the security agreement or other document;

(c) The registry accepts a notice presented by an authorized medium of communication (e.g. paper, electronic) except if:

- (i) It is not accompanied by the required fee;
- (ii) It fails to provide a grantor identifier sufficient to allow indexing; or
- (iii) It fails to provide some information with respect to any of the other items required under recommendation 57;

(d) The registrar does not require verification of the identity of the registrant or the existence of authorization for registration of the notice or conduct further scrutiny of the content of the notice;

(e) The record of the registry is centralized and contains all notices with respect to security rights registered under this law;

(f) The information provided on the record of the registry is available to the public;

(g) A search may be made without the need for the searcher to justify the reasons for the search;

(h) Notices are indexed and can be retrieved by searchers according to the name of the grantor or according to some other reliable identifier of the grantor;

(i) Fees for registration and for searching, if any, are set at a level no higher than necessary to permit cost recovery;

(j) If possible, the registration system is electronic. In particular:

- (i) Notices are stored in electronic form in a computer database;
- (ii) Registrants and searchers have immediate access to the registry record by electronic or similar means, including the Internet and electronic data interchange;
- (iii) The system is programmed to minimize the risk of entry of incomplete or irrelevant information; and
- (iv) The system is programmed to facilitate speedy and complete retrieval of information and to minimize the practical consequences of human error;

(k) Registrants may choose among multiple modes and points of access to the registry; and

(l) The registry, to the extent it is electronic, operates continuously except for scheduled maintenance, and, to the extent it is not electronic, operates during reliable and consistent service hours compatible with the needs of potential registry users.

Security and integrity of the registry

55. In order to ensure the security and integrity of the registry, the law should provide that the operational and legal framework of the registry should reflect the following characteristics:

(a) Although the day-to-day operation of the registry may be delegated to a private authority, the State retains the responsibility to ensure that it is operated in accordance with the governing legal framework;

- (b) The identity of a registrant is requested and maintained by the registry;²⁷
- (c) The registrant is obligated to forward a copy of a notice to the grantor named in the notice. Failure of the secured creditor to meet this obligation may result only in nominal penalties and any damages resulting from the failure that may be proven;
- (d) The registry is obligated to send promptly a copy of any changes to a registered notice to the person identified as the secured creditor in the notice;
- (e) A registrant can obtain a record of the registration as soon as the registration information is entered into the registry record; and
- (f) Multiple copies of all the information in the records of a registry are maintained and the entirety of the registry records can be reconstructed in the event of loss or damage.

Responsibility for loss or damage

56. The law should provide for the allocation of responsibility for loss or damage caused by an error in the administration or operation of the registration and searching system. If the system is designed to permit direct registration and searching by registry users without the intervention of registry personnel, the responsibility of the registry for loss or damage should be limited to system malfunction.

Required content of notice

57. The law should provide that the following information only is required to be provided in the notice:

- (a) The identifier of the grantor, satisfying the standard provided in recommendations 58-60, and the secured creditor or its representative and their addresses;
- (b) A description of the asset covered by the notice, satisfying the standard provided in recommendation 63;
- (c) The duration of the registration as provided in recommendation 66; and
- (d) If the State determines that the maximum monetary amount for which the security right may be enforced is helpful to facilitate subordinate lending, a statement of that maximum amount.

[Note to the Commission: The Commission may wish to consider three additional recommendations (entitled, for example, erroneous notices) along the following lines:

“X. The law should provide that an error in the identifier or address of the secured creditor or its representative does not render a registered notice ineffective as long as it has not seriously misled a reasonable searcher.

“Y. The law should provide that an error in the description of certain encumbered assets does not render a registered notice ineffective with respect to other assets sufficiently described.

²⁷ As to verification of the registrant's identity, see recommendation 54, subparagraph (d).

“Z. The law should provide that an error in the information provided in the notice with respect to the duration of registration and the maximum amount secured, if applicable, does not render a registered notice ineffective.”]

Sufficiency of grantor identifier

58. The law should provide that registration of a notice is effective only if it provides the grantor’s correct identifier or, in the case of an incorrect statement, if the notice would be retrieved by a search of the registry record under the correct identifier.

59. The law should provide that, where the grantor is a natural person, the identifier of the grantor for the purposes of effective registration is the grantor’s name, as it appears in a specified official document. Where necessary, additional information, such as the birth date or identity card number, should be required to uniquely identify the grantor.

60. The law should provide that, where the grantor is a legal person, the grantor’s identifier for the purposes of effective registration is the name that appears in the document constituting the legal person.

Impact of a change of the grantor’s identifier on the effectiveness of the registration

61. The law should provide that, if, after a notice is registered, the identifier of the grantor used in the notice changes and as a result the grantor’s identifier does not meet the standard provided in recommendations 58-60, the secured creditor may amend the registered notice to provide the new identifier in compliance with that standard. If the secured creditor does not register the amendment within [a short period of time to be specified] days after the change, the security right is ineffective against:

(a) A competing security right with respect to which a notice is registered or which is otherwise made effective against third parties before registration of the amendment; and

(b) A person that buys, leases or licenses the encumbered asset before registration of the amendment.

Impact of a transfer of an encumbered asset on the effectiveness of the registration

62. The law should provide that, if, after a notice is registered, the grantor transfers the encumbered asset, the secured creditor may amend the registered notice to provide the identifier of the transferee. If the secured creditor does not register the amendment within [a short period of time to be specified] days after the transfer, the security right is ineffective against:

(a) A competing security right with respect to which a notice is registered or which is otherwise made effective against third parties before registration of the amendment; and

(b) A person that buys, leases or licenses the encumbered asset before registration of the amendment.

Sufficiency of description of assets covered by a notice

63. The law should provide that a description of the encumbered assets in the notice that meets the requirements of recommendation 14, subparagraph (d) (chapter IV on the creation of a security right), is sufficient.

When notice may be registered

64. The law should provide that a notice with respect to a security right may be registered before or after creation of the security right, or conclusion of the security agreement.

One notice sufficient for multiple security rights arising from multiple agreements between the same parties

65. The law should provide that registration of a single notice is sufficient to achieve third-party effectiveness of one or more than one security right, whether they exist at the time of registration or are created thereafter, or whether they arise from one or more than one security agreement between the same parties.

Duration and extension of the registration of a notice

66. The law should either specify the duration of the effectiveness of the registration of a notice or permit the registrant to specify the duration in the notice at the time of registration and extend it at any time before its expiry. In either case, the secured creditor should be entitled to extend the period of effectiveness by submitting a notice of amendment to the registry at any time before the expiry of the effectiveness of the notice. If the law specifies the time of effectiveness of the registration, the extension period resulting from the registration of the notice of amendment should be an additional period equal to the initial period. If the law permits the registrant to specify the duration of the effectiveness of the registration, the extension period should be that specified in the notice of amendment.

Time of effectiveness of registration of a notice or amendment

67. The law should provide that registration of a notice or an amendment becomes effective when the information contained in the notice or the amendment is entered into the registry records so as to be available to searchers of the registry record.

Authority for registration

68. The law should provide that registration of a notice is ineffective unless authorized by the grantor in writing. The authorization may be given before or after registration. A written security agreement is sufficient to constitute authorization for the registration. The effectiveness of registration does not depend on the identity of the registrant.

Cancellation or amendment of notice

69. The law should provide that, if no security agreement has been concluded, the security right has been extinguished by full payment or otherwise, or a registered notice is not authorized by the grantor:

(a) The secured creditor is obliged to submit to the registry a notice of cancellation or amendment, to the extent appropriate, with respect to the relevant

registered notice not later than [a short period of time to be specified] days after the secured creditor's receipt of a written request of the grantor;

(b) The grantor is entitled to seek cancellation or appropriate amendment of the notice through a summary judicial or administrative procedure;

(c) The grantor is entitled to seek cancellation or appropriate amendment of the notice, as provided in subparagraph (b), even before the expiry of the period provided in subparagraph (a), provided that there are appropriate mechanisms to protect the secured creditor.

70. The law should provide that the secured creditor is entitled to submit to the registry a notice of cancellation or amendment, to the extent appropriate, with respect to the relevant registered notice at any time.

71. The law should provide that promptly after a registered notice has expired as provided in recommendation 66 or has been cancelled as provided in recommendation 69 or 70, the information contained in the notice should be removed from the records of the registry, which are accessible to the public. However, the information provided in the expired or cancelled or amended notice and the fact of expiration or cancellation or amendment should be archived so as to be capable of retrieval if necessary.

72. The law should provide that, in the case of an assignment of the secured obligation, the notice may be amended to indicate the name of the new secured creditor but the unamended notice remains effective.

VII. Priority of a security right

Purpose

The purpose of provisions on the priority of a security right is:

(a) To provide rules for determining the priority of a security right in an efficient and predictable way; and

(b) To facilitate transactions by which a grantor may create more than one security right in the same asset and thereby use the full value of its assets to obtain credit.

A. General recommendations

Priority between security rights in the same encumbered assets

73. The law should provide that priority between competing security rights in the same encumbered assets is determined as follows:

(a) As between security rights that were made effective against third parties by registration of a notice, priority is determined by the order of registration, regardless of the order of creation of the security rights;

(b) As between security rights that were made effective against third parties otherwise than by registration, priority is determined by the order of third-party effectiveness;

(c) As between a security right that was made effective against third parties by registration and a security right that was made effective against third parties otherwise than by registration, priority is determined (regardless of when creation occurs) by the order of registration or third-party effectiveness, whichever occurs first.

This recommendation is subject to the exceptions provided in recommendations 74, 75 and 84-106, as well as in recommendations 174-182 (chapter XI, unitary approach to acquisition financing).

Priority of a security or other right registered in a specialized registry or noted on a title certificate

74. The law should provide that a security right in an asset that is made effective against third parties by registration in a specialized registry or notation on a title certificate, as provided in recommendation 38 (chapter V on the third-party effectiveness of a security right), has priority as against:

(a) A security right in the same asset with respect to which a notice is registered in the general security rights registry or which is made effective against third parties by a method other than registration in a specialized registry or notation on a title certificate, regardless of the order; and

(b) A security right that is subsequently registered in the specialized registry or noted on a title certificate.

75. The law should provide that, if an encumbered asset is transferred, leased or licensed and, at the time of transfer, lease or licence, a security right in that asset is effective against third parties by registration in a specialized registry or notation on a title certificate, as provided in recommendation 38 (chapter V on the third-party effectiveness of a security right), the transferee, lessee or licensee takes its rights subject to the security right, except as provided in recommendations 76-78. However, if the security right has not been made effective against third parties by registration in a specialized registry or notation on a title certificate, a transferee, lessee or licensee takes its rights free of the security right.

Priority of rights of transferees, lessees and licensees of an encumbered asset

76. The law should provide that, if an encumbered asset is transferred, leased or licensed and a security right in that asset is effective against third parties at the time of the transfer, lease or licence, a transferee, lessee or licensee takes its rights subject to the security right except as provided in recommendations 75 and 77-79.

77. The law should provide that:

(a) A security right does not continue in an encumbered asset that the grantor sells or otherwise disposes of, if the secured creditor authorizes the sale or other disposition free of the security right; and

(b) The rights of a lessee or licensee of an encumbered asset are not affected by a security right if the secured creditor authorizes the grantor to lease or license the asset unaffected by the security right.

78. The law should provide that:

(a) A buyer of a tangible asset (other than a negotiable instrument or negotiable document) sold in the ordinary course of the seller's business takes free of a security right in the asset, provided that, at the time of the sale, the buyer does not have knowledge that the sale violates the rights of the secured creditor under the security agreement;

(b) The rights of a lessee of a tangible asset (other than a negotiable instrument or document) leased in the ordinary course of the lessor's business are not affected by a security right in the asset, provided that, at the time of the conclusion of the lease, the lessee does not have knowledge that the lease violates the rights of the secured creditor under the security agreement; and

(c) The rights of a non-exclusive licensee of an intangible asset licensed in the ordinary course of the licensor's business are not affected by a security right in the asset, provided that, at the time of the conclusion of the licence agreement, the licensee does not have knowledge that the licence violates the rights of the secured creditor under the security agreement.

79. The law should provide that, if a buyer acquires a right in an encumbered asset free of a security right, any person that subsequently acquires a right in the asset from the buyer also takes free of the security right. If the rights of a lessee or licensee are not affected by a security right, the rights of a sub-lessee or sub-licensee are also unaffected by the security right.

Priority of preferential claims

80. The law should limit, both in type and amount, preferential claims arising by operation of law that have priority as against security rights and, to the extent preferential claims exist, they should be described in the law in a clear and specific way.

Priority of rights of judgement creditors

81. The law should provide that, a security right has priority as against the rights of an unsecured creditor, unless the unsecured creditor, under other law, obtained a judgement or provisional court order against the grantor and took the steps necessary to acquire rights in assets of the grantor by reason of the judgement or provisional court order before the security right was made effective against third parties. The priority of the security right extends to credit extended by the secured creditor:

(a) Before the expiry of [a short period of time to be specified] days after the unsecured creditor notified the secured creditor that it had taken the steps necessary to acquire rights in the encumbered asset; or

(b) Pursuant to an irrevocable commitment (in a fixed amount or an amount to be fixed pursuant to a specified formula) of the secured creditor to extend credit, if the commitment was made before the unsecured creditor notified the secured creditor that it had taken the steps necessary to acquire rights in the encumbered asset.

This recommendation is subject to the exception in recommendation 179 (chapter XI, unitary approach to acquisition financing).

Priority of rights of persons providing services with respect to an encumbered asset

82. The law should provide that, if other law gives rights equivalent to security rights to a creditor that has provided services with respect to an encumbered asset (e.g. by repairing, storing or transporting it), such rights are limited to the asset in the possession of that creditor up to the reasonable value of the services rendered and have priority as against security rights in the asset that were made effective against third parties by one of the methods referred to in recommendation 32 or 34 (chapter V on the third-party effectiveness of a security right).

Priority of a supplier's reclamation right

83. The law should provide that, if other law provides that a supplier of tangible assets has the right to reclaim them, the right to reclaim is subordinate to a security right that was made effective against third parties before the supplier exercised its right.

Priority of a security right in an attachment to immovable property

84. The law should provide that a security right or any other right (such as the right of a buyer or lessee) in an attachment to immovable property that is created and made effective against third parties under immovable property law, as provided in recommendations 21 and 43 (chapter IV on the creation of a security right), has priority as against a security right in that attachment that is made effective against third parties by one of the methods referred to in recommendation 32 or 34 (chapter V on the third-party effectiveness of a security right).

85. The law should provide that a security right in a tangible asset that is an attachment to immovable property at the time the security right is made effective against third parties or that becomes an attachment to immovable property subsequently, which is made effective against third parties by registration in the immovable property registry as provided in recommendation 43 (chapter V on the third-party effectiveness of a security right), has priority as against a security right or any other right (such as the right of a buyer or lessor) in the related immovable property that is registered subsequently in the immovable property registry.

Priority of a security right in an attachment to movable assets

86. A security right or any other right (such as the right of a buyer or lessee) in an attachment to movable property that is made effective against third parties by registration in a specialized registry or by notation on a title certificate as provided in recommendation 42 (chapter V on the third-party effectiveness of a security right), has priority as against a security right or other right in the related movable property that is subsequently registered in the specialized registry or noted on the title certificate.

Priority of a security right in a mass or product

87. The law should provide that, if two or more security rights in the same tangible asset continue in a mass or product as provided in recommendation 22 (chapter IX on the creation of a security right), they retain the same priority as the

security rights in the asset had as against each other immediately before the asset became part of the mass or product.

88. The law should provide that, if security rights in separate tangible assets continue in the same mass or product and each security right is effective against third parties, the secured creditors are entitled to share in the aggregate maximum value of their security rights in the mass or product according to the ratio of the value of the respective security rights. For purposes of this formula, the maximum value of a security right is the lesser of the value determined pursuant to recommendation 22 (chapter IV on the creation of a security right) and the amount of the secured obligation.

89. The law should provide that an acquisition security right in a separate tangible asset that continues in a mass or product and is effective against third parties has priority as against a security right granted by the same grantor in the mass or product.

Irrelevance of knowledge of the existence of a security right

90. The law should provide that knowledge of the existence of a security right on the part of a competing claimant does not affect priority.²⁸

Subordination

91. The law should provide that a competing claimant entitled to priority may at any time subordinate its priority unilaterally or by agreement in favour of any other existing or future competing claimant.

Impact of continuity in third-party effectiveness on priority

92. The law should provide that, for the purpose of recommendation 73, the priority of a security right is not affected by a change in the method by which it is made effective against third parties, provided that there is no time when the security right is not effective against third parties.

93. The law should provide that, if a security right is covered by a registered notice or made effective against third parties and subsequently there is a period during which the security right is neither covered by a registered notice nor effective against third parties, the priority of the security right dates from the earliest time thereafter when the security right is either covered by a registered notice or made effective against third parties.

Priority of security rights securing existing and future obligations

94. The law should provide that, subject to recommendation 81, the priority of a security right extends to all secured obligations, regardless of the time when they are incurred.

²⁸ As for the impact of knowledge that a transaction violates the rights of a secured creditor, see recommendations 78, 99, subparagraph (b), 102 and 103.

Extent of priority

95. The law should provide that, if a State implements recommendation 57, subparagraph (d) (chapter VI on the registry system), the priority of the security right is limited to the maximum amount set out in the registered notice.

Application of priority rules to a security right in after-acquired assets

96. The law should provide that, for purposes of recommendation 73, subparagraphs (a) and (c), the priority of a security right extends to all encumbered assets covered by the registered notice, irrespective of whether they are acquired by the grantor or come into existence before, at or after the time of registration.

Application of priority rules to a security right in proceeds

97. The law should provide that, for purposes of recommendation 73, the time of third-party effectiveness or the time of registration of a notice as to a security right in an encumbered asset is also the time of third-party effectiveness or registration as to a security right in its proceeds.

B. Asset-specific recommendations**Priority of a security right in a negotiable instrument**

98. The law should provide that a security right in a negotiable instrument that is made effective against third parties by possession of the instrument, as provided in recommendation 37 (chapter V on the third-party effectiveness of a security right), has priority as against a security right in a negotiable instrument that is made effective against third parties by any other method.

99. The law should provide that a security right in a negotiable instrument that is made effective against third parties by a method other than possession of the instrument is subordinate to the rights of a secured creditor, buyer or other transferee (by agreement) that:

(a) Qualifies as a protected holder under the law governing negotiable instruments; or

(b) Takes possession of the negotiable instrument and gives value in good faith and without knowledge that the transfer is in violation of the rights of the secured creditor under the security agreement.

Priority of a security right in a right to payment of funds credited to a bank account

100. The law should provide that a security right in a right to payment of funds credited to a bank account that is made effective against third parties by control, as provided in recommendation 49 (chapter V on the third-party effectiveness of a security right), has priority as against a competing security right that is made effective against third parties by any other method. If a depositary bank concludes control agreements with more than one secured creditor, priority among those secured creditors is determined according to the order in which the control agreements are concluded. If the depositary bank is the secured creditor, its security

right has priority as against any other security right (including a security right made effective against third parties by a control agreement with the depositary bank even if the depositary bank's security right is later in time) except a security right of a secured creditor that obtains control by becoming the account holder.

101. The law should provide that a right under other law of a depositary bank to set off obligations owed to the depositary bank by the grantor against the grantor's right to payment of funds credited to a bank account has priority as against a security right except a security right of a secured creditor that obtains control by becoming the account holder.

102. The law should provide that, in the case of a transfer of funds from a bank account initiated by the grantor, the transferee of the funds takes free of a security right in the right to payment of funds credited to the bank account, unless the transferee has knowledge that the transfer violates the rights of the secured creditor under the security agreement. This recommendation does not adversely affect the rights of transferees of funds from bank accounts under other law.

Priority of a security right in money

103. The law should provide that a person that obtains possession of money that is subject to a security right takes the money free of the security right, unless that person has knowledge that the transfer violates the rights of the secured creditor under the security agreement. This recommendation does not adversely affect the rights of holders of money under other law.

Priority of a security right in a right to receive the proceeds under an independent undertaking

104. The law should provide that a security right in a right to receive the proceeds under an independent undertaking that is made effective against third parties by control has priority as against a security right made effective against third parties pursuant to recommendation 48 (chapter V on the third-party effectiveness of a security right). If control has been achieved by acknowledgement and inconsistent acknowledgements have been given to more than one secured creditor by a person, priority among those security rights is determined according to the order in which the acknowledgements were given.

Priority of a security right in a negotiable document or tangible assets covered by a negotiable document

105. The law should provide that a security right in a negotiable document and the tangible assets covered thereby is subordinate to any superior rights acquired by a transferee of the document under the law governing negotiable documents.

106. The law should provide that a security right in a tangible asset made effective against third parties by possession of a negotiable document has priority as against a competing security right made effective against third parties by another method. This rule does not apply to a security right in an asset other than inventory if the security right of the secured creditor not in possession of the negotiable document was made effective against third parties before the earlier of:

- (a) The time that the asset became covered by the negotiable document; and

(b) The time when an agreement was made between the grantor and the secured creditor in possession of the negotiable document providing for the asset to be covered by a negotiable document so long as the asset became so covered within [a short period of time to be specified] days from the date of the agreement.

VIII. Rights and obligations of the parties to a security agreement

Purpose

The purpose of provisions on the rights and obligations of the parties is to enhance efficiency of secured transactions and reduce transaction costs and potential disputes by:

(a) Providing mandatory rules relating to the rights and obligations of the party in possession of the encumbered asset;

(b) Providing non-mandatory rules relating to the rights and obligations of the parties that apply in cases where the parties have not addressed these matters in their agreement; and

(c) Providing non-mandatory rules to serve as a drafting aid or checklist of issues the parties may wish to address in their agreement.

A. General recommendations

Rights and obligations of the parties to a security agreement²⁹

107. The law should provide that the mutual rights and obligations of the parties are determined by:

(a) The terms and conditions set forth in that agreement, including any rules or general conditions referred to therein;

(b) Any usage to which they have agreed; and

(c) Unless otherwise agreed, any practices they have established between themselves.

Mandatory rules

108. The law should provide that the party in possession of an encumbered asset must take reasonable steps to preserve the asset and its value.

109. The secured creditor must return an encumbered asset in its possession if the security right has been extinguished by full payment or otherwise.³⁰

²⁹ For recommendation 107, see article 11 of the United Nations Assignment Convention.

³⁰ For the secured creditor's duty to cancel a registered notice, see recommendation 69, chapter VI on the registry system.

Non-mandatory rules

110. The law should provide that, unless otherwise agreed, the secured creditor is entitled:

- (a) To be reimbursed for reasonable expenses incurred for the preservation of an encumbered asset in its possession;
- (b) To make reasonable use of an encumbered asset in its possession and to apply the revenues it generates to the payment of the secured obligation; and
- (c) To inspect an encumbered asset in the possession of the grantor.

B. Asset-specific recommendations**Representations of the assignor³¹**

111. With respect to an assignment of a contractual receivable, the law should provide that:

- (a) Unless otherwise agreed between the assignor and the assignee, the assignor represents at the time of conclusion of the contract of assignment that:
 - (i) The assignor has the right to assign the receivable;
 - (ii) The assignor has not previously assigned the receivable to another assignee; and
 - (iii) The debtor of the receivable does not and will not have any defences or rights of set-off;
- (b) Unless otherwise agreed between the assignor and the assignee, the assignor does not represent that the debtor of the receivable has, or will have, the ability to pay.

Right to notify the debtor of the receivable

112. The law should provide that:

- (a) Unless otherwise agreed between the assignor and the assignee, the assignor or the assignee or both may send the debtor of the receivable notification of the assignment and a payment instruction, but after notification has been sent only the assignee may send such an instruction; and
- (b) Notification of the assignment or a payment instruction sent in breach of any agreement referred to in subparagraph (a) of this recommendation is not ineffective for the purposes of recommendation 117 (chapter IX on the rights and obligations of third-party obligors) by reason of such breach. However, nothing in this recommendation affects any obligation or liability of the party in breach of such an agreement for any damages arising as a result of the breach.

³¹ For recommendations 111-113, see articles 12-14 of the United Nations Assignment Convention.

Right to payment

113. The law should provide that:

(a) As between the assignor and the assignee, unless otherwise agreed and whether or not notification of the assignment has been sent:

(i) If payment in respect of the assigned receivable is made to the assignee, the assignee is entitled to retain the proceeds and tangible assets returned in respect of the assigned receivable;

(ii) If payment in respect of the assigned receivable is made to the assignor, the assignee is entitled to payment of the proceeds and also to tangible assets returned to the assignor in respect of the assigned receivable; and

(iii) If payment in respect of the assigned receivable is made to another person over whom the assignee has priority, the assignee is entitled to payment of the proceeds and also to tangible assets returned to such person in respect of the assigned receivable;

(b) The assignee may not retain more than the value of its right in the receivable.

IX. Rights and obligations of third-party obligors**Purpose**

The purpose of provisions on the rights and obligations of third-party obligors is to enhance the efficiency of secured transactions where the encumbered asset is a payment obligation or other performance owed by a third party to the grantor by:

(a) Providing rules relating to rights and obligations of parties to the assignment of a receivable and the protection of the debtor of the receivable;

(b) Providing rules to ensure the coherence of secured transactions law with other law relating to the rights and obligations arising under negotiable instruments and negotiable documents; and

(c) Providing rules to ensure the coherence of the secured transactions regime with other law governing the rights and obligations of depositary banks, and of the guarantor/issuer, confirmer or nominated person under an independent undertaking.

A. Rights and obligations of the debtor of the receivable³²**Protection of the debtor of the receivable**

114. The law should provide that:

(a) Except as otherwise provided in this law, an assignment does not, without the consent of the debtor of the receivable, affect the rights and obligations of the debtor of the receivable, including the payment terms contained in the original contract; and

³² For recommendations 115-120, see articles 16-21 of the United Nations Assignment Convention.

(b) A payment instruction may change the person, address or account to which the debtor of the receivable is required to make payment, but may not change:

- (i) The currency of payment specified in the original contract; or
- (ii) The State specified in the original contract in which payment is to be made to a State other than that in which the debtor of the receivable is located.

Notification of the assignment

115. The law should provide that:

(a) Notification of the assignment or a payment instruction is effective when received by the debtor of the receivable if it is in a language that is reasonably expected to inform the debtor of the receivable about its contents. It is sufficient if notification of the assignment or a payment instruction is in the language of the original contract;

(b) Notification of the assignment or a payment instruction may relate to receivables arising after notification; and

(c) Notification of a subsequent assignment constitutes notification of all prior assignments.

Discharge of the debtor of the receivable by payment

116. The law should provide that:

(a) Until the debtor of the receivable receives notification of the assignment, it is entitled to be discharged by paying in accordance with the original contract;

(b) After the debtor of the receivable receives notification of the assignment, subject to subparagraphs (c)-(h) of this recommendation, it is discharged only by paying the assignee or, if otherwise instructed in the notification of the assignment or subsequently by the assignee in a writing received by the debtor of the receivable, in accordance with such payment instruction;

(c) If the debtor of the receivable receives more than one payment instruction relating to a single assignment of the same receivable by the same assignor, it is discharged by paying in accordance with the last payment instruction received from the assignee before payment;

(d) If the debtor of the receivable receives notification of more than one assignment of the same receivable made by the same assignor, it is discharged by paying in accordance with the first notification received;

(e) If the debtor of the receivable receives notification of one or more subsequent assignments, it is discharged by paying in accordance with the notification of the last of such subsequent assignments;

(f) If the debtor of the receivable receives notification of the assignment of a part of or an undivided interest in one or more receivables, it is discharged by paying in accordance with the notification or in accordance with this recommendation as if the debtor of the receivable had not received the notification. If the debtor of the receivable pays in accordance with the notification, it is discharged only to the extent of the part or undivided interest paid;

(g) If the debtor of the receivable receives notification of the assignment from the assignee, it is entitled to request the assignee to provide within a reasonable period of time adequate proof that the assignment from the initial assignor to the initial assignee and any intermediate assignment have been made and, unless the assignee does so, the debtor of the receivable is discharged by paying in accordance with this recommendation as if the notification from the assignee had not been received. Adequate proof of an assignment includes but is not limited to any writing emanating from the assignor and indicating that the assignment has taken place; and

(h) This recommendation does not affect any other ground on which payment by the debtor of the receivable to the person entitled to payment, to a competent judicial or other authority, or to a public deposit fund discharges the debtor of the receivable.

Defences and rights of set-off of the debtor of the receivable

117. The law should provide that:

(a) In a claim by the assignee against the debtor of the receivable for payment of the assigned receivable, the debtor of the receivable may raise against the assignee all defences and rights of set-off arising from the original contract, or any other contract that was part of the same transaction, of which the debtor of the receivable could avail itself as if the assignment had not been made and such claim were made by the assignor;

(b) The debtor of the receivable may raise against the assignee any other right of set-off, provided that it was available to the debtor of the receivable at the time notification of the assignment was received by the debtor of the receivable; and

(c) Notwithstanding subparagraphs (a) and (b) of this recommendation, defences and rights of set-off that the debtor of the receivable may raise pursuant to recommendation 24, subparagraph (b), or recommendation 25, subparagraph (e) (chapter IV on the creation of a security right), against the assignor for breach of an agreement limiting in any way the assignor's right to make the assignment are not available to the debtor of the receivable against the assignee.

Agreement not to raise defences or rights of set-off

118. The law should provide that:

(a) The debtor of the receivable may agree with the assignor in a writing signed by the debtor of the receivable not to raise against the assignee the defences and rights of set-off that it could raise pursuant to recommendation 117. Such an agreement precludes the debtor of the receivable from raising against the assignee those defences and rights of set-off;

(b) The debtor of the receivable may not waive defences:

(i) Arising from fraudulent acts on the part of the assignee; or

(ii) Based on the incapacity of the debtor of the receivable; and

(c) Such an agreement may be modified only by an agreement in a writing signed by the debtor of the receivable. The effect of such a modification as against the assignee is determined by recommendation 119, subparagraph (b).

Modification of the original contract

119. The law should provide that:

(a) An agreement concluded before notification of the assignment between the assignor and the debtor of the receivable that affects the assignee's rights is effective as against the assignee, and the assignee acquires corresponding rights;

(b) An agreement concluded after notification of the assignment between the assignor and the debtor of the receivable that affects the assignee's rights is ineffective as against the assignee unless:

(i) The assignee consents to it; or

(ii) The receivable is not fully earned by performance and either the modification is provided for in the original contract or, in the context of the original contract, a reasonable assignee would consent to the modification; and

(c) Subparagraphs (a) and (b) of this recommendation do not affect any right of the assignor or the assignee arising from breach of an agreement between them.

Recovery of payments

120. The law should provide that failure of the assignor to perform the original contract does not entitle the debtor of the receivable to recover from the assignee a sum paid by the debtor of the receivable to the assignor or the assignee.

B. Rights and obligations of the obligor under a negotiable instrument

121. The law should provide that a secured creditor's rights in a negotiable instrument are, as against a person obligated on the negotiable instrument, subject to the law governing negotiable instruments.

C. Rights and obligations of the depositary bank

122. The law should provide that:

(a) The creation of a security right in a right to payment of funds credited to a bank account does not affect the rights and obligations of the depositary bank without its consent; and

(b) Any rights of set-off that the depositary bank may have under other law are not impaired by reason of any security right that the depositary bank may have in a right to payment of funds credited to a bank account.

123. The law should provide that it does not obligate a depositary bank:

(a) To pay any person other than a person that has control with respect to funds credited to a bank account;

(b) To respond to requests for information about whether a control agreement or a security right in its own favour exists and whether the grantor retains the right to dispose of the funds credited in the account; or

(c) To enter into a control agreement.

D. Rights and obligations of the guarantor/issuer, confirmer or nominated person of an independent undertaking

124. The law should provide that:

(a) A secured creditor's right in the right to receive the proceeds under an independent undertaking is subject to the rights, under the law and practice governing independent undertakings, of a guarantor/issuer, confirmer or nominated person and of any other beneficiary named in the undertaking or to whom a transfer of the right to draw has been effected;

(b) The rights of a transferee of an independent undertaking are not affected by a security right in the right to receive the proceeds under the independent undertaking acquired from the transferor or any prior transferor; and

(c) The independent rights of a guarantor/issuer, confirmer, nominated person or transferee of an independent undertaking are not adversely affected by reason of any security right it may have in the right to receive proceeds under the independent undertaking.

125. The law should provide that a guarantor/issuer, confirmer or nominated person is not obligated to pay any person other than a confirmer, a nominated person, a named beneficiary, an acknowledged transferee of the independent undertaking or an acknowledged assignee of the right to receive the proceeds under an independent undertaking.

126. The law should provide that, if a secured creditor obtains control by becoming an acknowledged assignee of the proceeds under an independent undertaking, the secured creditor has the right to enforce the acknowledgement against the guarantor/issuer, confirmer or nominated person that made the acknowledgement.

E. Rights and obligations of the issuer of a negotiable document

127. The law should provide that a secured creditor's rights in a negotiable document are, as against the issuer or any other person obligated on the negotiable document, subject to the law governing negotiable documents.

X. Enforcement of a security right

Purpose

The purpose of provisions on enforcement of security rights is to provide:

(a) Clear, simple and efficient methods for the enforcement of security rights after debtor default;

(b) Methods designed to maximize the net amount realized from the encumbered assets, for the benefit of the grantor, the debtor or any other person that owes payment of the secured obligation, the secured creditor and other creditors with a right in the encumbered assets; and

(c) Expeditious judicial and, subject to appropriate safeguards, non-judicial methods for the secured creditor to exercise its rights.

A. General recommendations

General standard of conduct in the context of enforcement

128. The law should provide that a person must enforce its rights and perform its obligations under the provisions on enforcement in good faith and in a commercially reasonable manner.

Limitations on party autonomy

129. The law should provide that the general standard of conduct provided in recommendation 128 cannot be waived unilaterally or varied by agreement at any time.

130. The law should provide that, subject to recommendation 129, the grantor and any other person that owes payment or other performance of the secured obligation may waive unilaterally or vary by agreement any of its rights under the provisions on enforcement, but only after default.

131. The law should provide that, subject to recommendation 129, the secured creditor may waive unilaterally or vary by agreement any of its rights under the provisions on enforcement.

132. The law should provide that a variation of rights by agreement may not adversely affect the rights of any person not a party to the agreement. A person challenging the effectiveness of the agreement on the ground that is inconsistent with recommendation 129, 130 or 131 has the burden of proof.

Liability

133. The law should provide that, if a person fails to comply with its obligations under the provisions on enforcement, it is liable for damages caused by such failure.

Judicial or other relief for non-compliance

134. The law should provide that the debtor, the grantor or any other interested person (e.g. a secured creditor with a lower priority ranking than that of the enforcing secured creditor, a guarantor or a co-owner of the encumbered assets) is entitled at any time to apply to a court or other authority for relief from the secured creditor's failure to comply with its obligations under the provisions on the enforcement of a security right.

Expeditious judicial proceedings

135. The law should provide for expeditious proceedings to accommodate situations where the secured creditor, the grantor or any other person that owes performance of the secured obligation, or claims to have a right in an encumbered asset, applies to a court or other authority with respect to the exercise of post-default rights.

Post-default rights of the grantor

136. The law should provide that, after default, the grantor is entitled to exercise one or more of the following rights:

(a) Pay in full the secured obligation and obtain a release from the security right of all encumbered assets, as provided in recommendation 137;

(b) Apply to a court or other authority for relief if the secured creditor is not complying with its obligations under the provisions of this law, as provided in recommendation 134;

(c) [Propose to the secured creditor, or] reject the proposal of the secured creditor[,] that the secured creditor acquire an encumbered asset in total or partial satisfaction of the secured obligation, as provided in recommendation 156; and

(d) Exercise any other right provided in the security agreement or any law.

Extinction of the security right after full satisfaction of the secured obligation

137. The law should provide that the debtor, the grantor or any other interested person (e.g. a secured creditor whose security right has lower priority than that of the enforcing secured creditor, a guarantor or a co-owner of the encumbered asset) is entitled to satisfy the secured obligation in full, including payment of the costs of enforcement up to the time of full satisfaction. This right may be exercised until the disposition, acceptance or collection of an encumbered asset by the secured creditor [or the conclusion of an agreement by the secured creditor to dispose of the encumbered asset]. If all commitments to extend credit have terminated, full satisfaction of the secured obligation extinguishes the security right in all encumbered assets, subject to any rights of subrogation in favour of the person satisfying the secured obligation.

[Note to the Commission: The Commission may wish to note that the bracketed text in this recommendation is intended to reflect the common practice of a secured creditor to enter into a contract to dispose of an encumbered asset before the actual disposition takes place.]

Post-default rights of the secured creditor

138. The law should provide that, after default, the secured creditor is entitled to exercise one or more of the following rights with respect to an encumbered asset:

(a) Obtain possession of a tangible encumbered asset, as provided in recommendations 143 and 144;

(b) Sell or otherwise dispose of, lease or license an encumbered asset, as provided in recommendations 145-146;

(c) Propose that the secured creditor acquire an encumbered asset in total or partial satisfaction of the secured obligation, as provided in recommendations 153-155;

(d) Enforce its security right in an attachment, as provided in recommendations 162 and 163;

(e) Collect on or otherwise enforce a security right in an encumbered asset that is a receivable, negotiable instrument, right to payment of funds credited to a bank account or right to receive the proceeds under an independent undertaking, as provided in recommendations 164-172;

(f) Enforce rights under a negotiable document, as provided in recommendation 173; and

(g) Exercise any other right provided in the security agreement (except to the extent inconsistent with the provisions of this law) or any law.

Judicial and extrajudicial methods of exercising post-default rights

139. The law should provide that, after default, the secured creditor may exercise its rights provided in recommendation 138 either by applying to a court or other authority, or without application to a court or other authority. Extrajudicial exercise of the secured creditor's rights is subject to the general standard of conduct provided in recommendation 128 and the requirements provided in recommendations 144-148 with respect to extrajudicial obtaining of possession and disposition of an encumbered asset.

Cumulative post-default rights

140. The law should provide that the exercise of one post-default right does not prevent the exercise of another right, except to the extent that the exercise of one right has made the exercise of another right impossible.

Post-default rights with respect to the secured obligation

141. The law should provide that the exercise of a post-default right with respect to an encumbered asset does not prevent the exercise of a post-default right with respect to the obligation secured by that asset, and vice versa.

Right of higher-ranking secured creditor to take over enforcement

142. The law should provide that, if a secured creditor has commenced enforcement by taking any of the actions described in the recommendations on enforcement or a judgement creditor has taken the steps referred to in recommendation 81 (chapter VII on the priority of a security right) a secured creditor whose security right has priority as against that of the enforcing secured creditor or the enforcing judgement creditor is entitled to take control of the enforcement process at any time before final disposition or acquisition [or collection] of an encumbered asset [or the conclusion of an agreement by the secured creditor to dispose of the encumbered asset]. The right to take control includes the right to enforce by any method available under the recommendations in this chapter.

[Note to the Commission: The Commission may wish to delete the first bracketed text if it decides to adopt the new recommendation set out in the note after recommendation 164. The second bracketed text is intended to conform this recommendation to the bracketed text in recommendation 137.]

Secured creditor's right to possession of an encumbered asset

143. The law should provide that after default the secured creditor is entitled to possession of a tangible encumbered asset.

Extrajudicial obtaining of possession of an encumbered asset

144. The law should provide that the secured creditor may elect to obtain possession of a tangible encumbered asset without applying to a court or other authority only if:

(a) The grantor has consented in the security agreement to the secured creditor obtaining possession without applying to a court or other authority;

(b) The secured creditor has given the grantor and any person in possession of the encumbered asset notice of default and of the secured creditor's intent to obtain possession without applying to a court or other authority; and

(c) At the time the secured creditor seeks to obtain possession of the encumbered asset the grantor does not object.

[Note to the Commission: The Commission may wish to consider whether subparagraph (c) should also refer to the person in possession of the encumbered asset, and not just to the grantor.]

The Commission may also wish to consider whether, if at the time the secured creditor seeks to obtain possession of the encumbered asset the grantor and any other person in possession affirmatively consents, the requirements of subparagraphs (a), (b) and (c) do not need to be met. This result could be implemented by the addition in a separate sentence of text along the following lines:

"The requirements of subparagraphs (a), (b) and (c) of this recommendation need not be met if, at the time the secured creditor seeks to obtain possession of the encumbered asset, the grantor and any other person in possession of the encumbered asset affirmatively consent".]

Extrajudicial disposition of an encumbered asset

145. The law should provide that, after default, a secured creditor is entitled, without applying to a court or other authority, to sell or otherwise dispose of, lease or license an encumbered asset to the extent of the grantor's rights in the encumbered asset. Subject to the standard of conduct provided in recommendation 128, a secured creditor that elects to exercise this right may select the method, manner, time, place and other aspects of the disposition, lease or licence.

Advance notice of extrajudicial disposition of an encumbered asset

146. The law should provide that, after default, the secured creditor must give notice of its intention to sell or otherwise dispose of, lease or licence an encumbered asset without applying to a court or other authority. The notice need not be given if the encumbered asset is perishable, may decline in value speedily or is of a kind sold on a recognized market.

147. The law should provide rules ensuring that the notice referred to in recommendation 146 can be given in an efficient, timely and reliable way so as to protect the grantor or other interested parties, while, at the same time, avoiding having a negative effect on the secured creditor's remedies and the potential net realization value of the encumbered assets.

148. With respect to the notice referred to in recommendation 146, the law should:

(a) Provide that the notice must be given to:

(i) The grantor, the debtor and any other person that owes performance of the secured obligation;

(ii) Any person with rights in the encumbered asset that, more than [to be specified] days before the sending of the notice by the secured creditor to the grantor, notifies in writing the secured creditor of those rights;

(iii) Any other secured creditor that, more than [to be specified] days before the notice is sent to the grantor, registered a notice with respect to a security right in the encumbered asset that is indexed under the identifier of the grantor; and

(iv) Any other secured creditor that was in possession of the encumbered asset at the time when the enforcing secured creditor took possession of the asset;

(b) State the manner in which the notice must be given, its timing and its minimum contents, including whether the notice must contain an accounting of the amount then owed and a reference to the right of the debtor or the grantor to obtain the release of the encumbered assets from the security right as provided in recommendation 137; and

(c) Provide that the notice must be in a language that is reasonably expected to inform its recipients about its contents.

[Note to the Commission: The Commission may wish to consider whether subparagraph (c) should include language along the following lines:

“It is sufficient if the notice is in the language of the security agreement being enforced”.

Addition of this text would conform subparagraph (c) to article 16, paragraph 1, of the United Nations Assignment Convention, on which subparagraph (c) is based. The result would be that, if the recipients of the notice are located in several countries, it would be enough if the notice is in the language of the relevant security agreement.]

Distribution of proceeds of disposition of an encumbered asset

149. The law should provide that, in the case of extrajudicial disposition of an encumbered asset [or collection of a receivable, negotiable instrument or other obligation], the enforcing secured creditor must apply the net proceeds of its enforcement (after deducting costs of enforcement) to the secured obligation. Except as provided in recommendation 150, the enforcing secured creditor must pay any surplus remaining to any subordinate competing claimant that, prior to any distribution of the surplus, notified the enforcing secured creditor of the subordinate competing claimant's claim, to the extent of the amount of that claim. The balance remaining, if any, must be remitted to the grantor.

[Note to the Commission: The Commission may wish to replace the bracketed text in this recommendation with a new recommendation set out in the note after recommendation 164.]

150. The law should also provide that, in the case of extrajudicial disposition of an encumbered asset, whether or not there is any dispute as to the entitlement of any competing claimant or as to the priority of payment, the enforcing secured creditor may, in accordance with generally applicable procedural rules, pay the surplus to a competent judicial or other authority or to a public deposit fund for distribution. The surplus should be distributed in accordance with the provisions of this law on priority.

151. The law should provide that distribution of the proceeds realized by a judicial disposition or other officially administered enforcement process is to be made

pursuant to the general rules of the State governing execution proceedings, but in accordance with the provisions of this law on priority.

152. The law should provide that [, unless otherwise agreed,] the debtor and any other person that owes payment of the secured obligation remain liable for any shortfall owing after application of the net proceeds of enforcement to the secured obligation. *[Note to the Commission: The Commission may wish to delete the bracketed text as recommendations 8 and 130 provide for party autonomy. If the bracketed text were retained, it might need to be added in all recommendations that are subject to party autonomy so as to avoid a negative implication as to the application of the principle of party autonomy.]*

Acquisition of encumbered assets in satisfaction of the secured obligation

153. The law should provide that, after default, the secured creditor may propose in writing to acquire one or more of the encumbered assets in total or partial satisfaction of the secured obligation.

154. With respect to the proposal referred to in recommendation 153, the law should:

(a) Provide that the proposal must be sent to:

(i) The grantor, the debtor and any other person that owes payment or other performance of the secured obligation (e.g. a guarantor);

(ii) Any person with rights in the encumbered asset that, more than [to be specified] days before the proposal is sent by the secured creditor to the grantor, has notified in writing the secured creditor of those rights;

(iii) Any other secured creditor that, more than [to be specified] days before the proposal is sent by the secured creditor to the grantor, registered a notice with respect to a security right in the encumbered asset indexed under the identifier of the grantor; and

(iv) Any other secured creditor that was in possession of the encumbered asset at the time the secured creditor took possession; and

(b) Provide that the proposal must specify the amount owed as of the date the proposal is sent and the amount of the obligation that is proposed to be satisfied by acquiring the encumbered asset.

155. The law should provide that the secured creditor may acquire the encumbered asset as provided in recommendation 153, unless the secured creditor receives an objection in writing from any person entitled to receive a proposal under recommendation 154 within [a short period of time to be specified] days, after the proposal is sent. In the case of a proposal for the acquisition of the encumbered asset in partial satisfaction, affirmative consent by each addressee of the proposal is necessary.

[Note to the Commission: The Commission may wish to note that this recommendation was aligned with the preceding recommendations by referring to the secured creditor “receiving” an objection in writing.]

156. The law should provide that the grantor may make a proposal such as that referred to in recommendation 153 and if the secured creditor accepts it, the secured creditor must proceed as provided in recommendations 154 and 155.

Rights acquired through judicial disposition

157. The law should provide that, if a secured creditor disposes of an encumbered asset through a judicial or other officially administered process, the rights acquired by the transferee are determined by the general rules of the State governing execution proceedings.

Rights acquired through extrajudicial disposition

158. The law should provide that, if a secured creditor sells or otherwise disposes of an encumbered asset without applying to a court or other authority, in accordance with this law, a person that acquires the grantor's right in the asset takes the asset subject to rights that have priority as against the security right of the enforcing secured creditor, but free of rights of the enforcing secured creditor and any competing claimant whose right has a lower priority than that of the enforcing secured creditor. The same rule applies to rights in an encumbered asset acquired by a secured creditor that has acquired the asset in total or partial satisfaction of the secured obligation.

159. The law should provide that, if a secured creditor leases or licenses an encumbered asset without applying to a court or other authority, in accordance with the law, a lessee or licensee is entitled to the benefit of the lease or licence during its term, except as against rights that have priority over the right of the enforcing secured creditor.

160. The law should provide that, if the secured creditor sells or otherwise disposes of, leases or licenses the encumbered asset not in accordance with the recommendations in this chapter, a good faith acquirer, lessee or licensee of the encumbered asset acquires the rights or benefits described in recommendations 158 and 159.

Intersection of movable and immovable property enforcement regimes

161. The law should provide that:

(a) The secured creditor may elect to enforce a security right in an attachment to immovable property in accordance with the recommendations in this chapter or the law governing enforcement of encumbrances in immovable property; and

(b) If an obligation is secured by both movable and immovable property of a grantor, the secured creditor may elect to enforce:

(i) The security right in the movable property under the provisions on enforcement of a security right in movable assets recommendations in this chapter and the encumbrance in the immovable property under the law governing enforcement of encumbrances in immovable property; or

(ii) Both rights under the law governing enforcement of encumbrances in immovable property.

Enforcement of a security right in attachments

162. The law should provide that a secured creditor with a security right in an attachment to immovable property is entitled to enforce its security right only if it has priority as against competing rights in the immovable property. A creditor with a competing right in immovable property that has lower priority is entitled to pay off the obligation secured by the security right of the enforcing secured creditor in the attachment. The enforcing secured creditor is liable for any damage to the immovable property caused by the act of removal other than any diminution in its value attributable solely to the absence of the attachment.

163. [The law should provide that a secured creditor with a security right in an attachment to a movable asset is entitled to enforce its security right in the attachment. A creditor with higher priority is entitled to take control of the enforcement process, as provided in recommendation 142. A creditor with lower priority may pay off the obligation secured by the security right of the enforcing secured creditor in the attachment. The enforcing secured creditor is liable for any damage to the movable asset caused by the act of removal other than any diminution in its value attributable solely to the absence of the attachment.]

[Note to the Commission: The Commission may wish to consider and approve this recommendation, which was added to address the issue of the enforcement of a security right in an attachment to movable property.]

B. Asset-specific recommendations

Application of the chapter on enforcement to outright transfers of receivables

164. The law should provide that the recommendations in this chapter do not apply to the collection or other enforcement of a receivable assigned by an outright transfer with the exception of:

- (a) Recommendation 128 in the case of an outright transfer with recourse; and
- (b) Recommendations 165 and 166.

[Note to the Commission: The Commission may wish to replace the bracketed text in recommendation 142 with text along the following lines:

“The law should provide that, in the case of collection or other enforcement of a receivable, negotiable instrument or enforcement of a claim, the enforcing secured creditor must apply the net proceeds of its enforcement (after deducting costs of enforcement) to the secured obligation. The enforcing secured creditor must pay any surplus remaining to the competing claimants that, prior to any distribution of the surplus, notified the enforcing secured creditor of the competing claimant’s claim, to the extent of that claim. The balance remaining, if any, must be remitted to the grantor.”

The second sentence of this text is intended to give some protection to a secured creditor with a higher priority status than that of the enforcing secured creditor (“senior secured creditor”). Collection of receivables by a junior secured creditor should be distinguished from disposition of encumbered assets by a junior

secured creditor. A senior secured creditor is protected because its security right in the asset disposed of continues (see recommendation 158).]

Enforcement of a security right in a receivable

165. The law should provide that, in the case of a receivable assigned by an outright transfer, subject to recommendations 114-120 (chapter IX on the rights and obligations of third-party obligors), the assignee has the right to collect or otherwise enforce the receivable. In the case of a receivable assigned by way of security, the assignee is entitled, subject to recommendations 114-120, to collect or otherwise enforce the receivable after default, or before default with the agreement of the assignor.

166. The law should provide that the assignee's right to collect or otherwise enforce a receivable includes the right to collect or otherwise enforce any personal or property right that secures payment of the receivable.

Enforcement of a security right in a negotiable instrument

167. The law should provide that, after default or before default with the agreement of the grantor, the secured creditor is entitled, subject to recommendation 121 (chapter IX on the rights and obligations of third-party obligors), to collect or otherwise enforce a negotiable instrument that is an encumbered asset against a person obligated on that instrument.

168. The law should provide that the secured creditor's right to collect or otherwise enforce a negotiable instrument includes the right to collect or otherwise enforce any personal or property right that secures payment of the negotiable instrument.

Enforcement of a security right in a right to payment of funds credited to a bank account

169. The law should provide that, after default or before default with the agreement of the grantor, a secured creditor with a security right in a right to payment of funds credited to a bank account is entitled, subject to recommendations 122 and 123 (chapter IX on the rights and obligations of third-party obligors), to collect or otherwise enforce its right to payment of the funds.

170. The law should provide that a secured creditor that has control is entitled, subject to recommendations 122 and 123 (chapter IX on the rights and obligations of third-party obligors), to enforce its security right without having to apply to a court or other authority.

171. The law should provide that a secured creditor that does not have control is entitled, subject to recommendations 122 and 123 (chapter IX on the rights and obligations of third-party obligors), to collect or otherwise enforce the security right in the right to payment of funds credited to a bank account against the depositary bank only pursuant to a court order, unless the depositary bank agrees otherwise.

Enforcement of a security right in a right to receive the proceeds under an independent undertaking

172. The law should provide that, after default or before default with the agreement of the grantor, a secured creditor with a security right in a right to receive

the proceeds under an independent undertaking is entitled, subject to recommendations 124-126 (chapter IX on the rights and obligations of third-party obligors), to collect or otherwise enforce its right in the right to receive the proceeds under the independent undertaking.

Enforcement of a security right in a negotiable document or tangible assets covered by a negotiable document

173. The law should provide that, after default or before default with the agreement of the grantor, the secured creditor is entitled, subject to recommendation 127 (chapter IX on the rights and obligations of third-party obligors), to enforce a security right in a negotiable document or the tangible assets covered by the document.

XI. Acquisition financing

Option A: Unitary approach to acquisition financing*

Purpose

The purpose of provisions on acquisition security rights is:

- (a) To recognize the importance and facilitate the use of acquisition financing as a source of affordable credit, especially for small- and medium-sized businesses;
- (b) To provide for equal treatment of all providers of acquisition financing; and
- (c) To facilitate secured transactions in general by creating transparency with respect to acquisition financing.

An acquisition security right as a security right

174. The law should provide that an acquisition security right is a security right. Thus, all the recommendations governing security rights, including those on creation, third-party effectiveness (except as provided in recommendation 175), registration, enforcement and the law applicable to a security right, apply to acquisition security rights. The recommendations on priority also apply (except as provided in recommendations 176-182).

Third-party effectiveness and priority of an acquisition security right in consumer goods

175. The law should provide that an acquisition security right in consumer goods is effective against third parties upon its creation and, except as provided in recommendation 177, has priority as against a competing non-acquisition security right created by the grantor.

* A State may adopt option A (unitary approach to acquisition financing), i.e. recommendations 174-183, or option B (non-unitary approach to acquisition financing), i.e. recommendations 184-199. The recommendations outside this chapter are generally applicable except to the extent modified by the recommendations in this chapter.

Priority of an acquisition security right in a tangible asset

176. The law should provide that, except as provided in recommendation 177:

Alternative A**

(a) An acquisition security right in a tangible asset other than inventory or consumer goods has priority as against a competing non-acquisition security right created by the grantor (even if a notice with respect to that security right was registered in the general security rights registry before registration of a notice with respect to the acquisition security right), provided that:

- (i) The acquisition secured creditor retains possession of the asset; or
- (ii) A notice with respect to the acquisition security right is registered in the general security rights registry not later than [specify a short time period, such as 20 or 30 days] after the grantor obtains possession of the asset;

(b) An acquisition security right in inventory has priority as against a competing non-acquisition security right created by the grantor (even if that security right became effective against third parties before the acquisition security right became effective against third parties), provided that:

- (i) The acquisition secured creditor retains possession of the inventory; or

- (ii) Before delivery of the inventory to the grantor:

a. A notice with respect to the acquisition security right is registered in the general security rights registry; and

b. A secured creditor with an earlier-registered non-acquisition security right created by the grantor in inventory of the same kind is notified by the acquisition secured creditor that it has or intends to acquire an acquisition security right. The notice must describe the inventory sufficiently to enable the non-acquisition secured creditor to identify the inventory that is the object of the acquisition security right;

(c) A notice, sent pursuant to subparagraph (b)(ii) b. of this recommendation, may cover acquisition security rights under multiple transactions between the same parties without the need to identify each transaction. The notice is sufficient only for security rights in tangible assets of which the grantor obtains possession within a period of [specify time, such as five years] after the notice is given.

Alternative B

an acquisition security right in a tangible assets other than consumer goods has priority as against a competing non-acquisition security right created by the grantor (even if a notice of that security right was registered in the general security rights registry before registration of a notice of the acquisition security right), provided that:

- (a) The acquisition secured creditor retains possession of the asset; or

** A State may adopt alternative A or alternative B of recommendation 176.

(b) A notice relating to the acquisition security right is registered in the general security rights registry not later than [a short time period, such as 20 or 30 days, to be specified] after the grantor obtains possession of the asset.

[Note to the Commission: The Commission may wish to note that alternative A draws a distinction between tangible assets other than inventory and inventory, while alternative B does not make such a distinction. Such alternatives are provided to implement the decision of the Commission to parallel the language included in recommendation 189 so as to ensure functional equivalence of the unitary and the non-unitary approaches (see A/62/17 (Part I), para. 63). In view of the fact that retention of title and financial lease rights are typically non-possessory rights (and in any case the general recommendations about third-party effectiveness obtained by possession remain applicable, the Commission may wish to consider whether subparagraphs (a)(i) and (b)(i) of alternative A and subparagraph (a) of alternative B are necessary. The same question arises with respect to recommendation 189 below.]

Priority of a security right registered in a specialized registry or noted on a title certificate

177. The law should provide that the priority of an acquisition security right under recommendation 176 does not override the priority of a security right or other right registered in a specialized registry or noted on a title certificate under recommendation 74 (chapter VII on the priority of a security right).

Priority between competing acquisition security rights

178. The law should provide that the priority between competing acquisition security rights is determined according to the general priority rules applicable to non-acquisition security rights, unless one of the acquisition security rights is an acquisition security right of a supplier that was made effective against third parties within the period specified in recommendation 176, in which case the supplier's acquisition security right has priority as against all competing acquisition security rights.

Priority of an acquisition security right as against the right of a judgement creditor

179. The law should provide that an acquisition security right that is made effective against third parties within the period specified in recommendation 176 has priority as against the rights of an unsecured creditor that would otherwise have priority under recommendation 81 (chapter VII on the priority of a security right).

Priority of an acquisition security right in an attachment to immovable property as against an earlier registered encumbrance in the immovable property

180. The law should provide that an acquisition security right in a tangible asset that becomes an attachment to immovable property has priority as against third parties with existing rights in the immovable property (other than an encumbrance securing a loan financing the construction of the immovable property), provided that notice of the acquisition security right is registered in the immovable property

registry not later than [a short time period, such as 20-30 days, to be specified] days after the asset becomes an attachment.

Priority of an acquisition security right in proceeds of tangible assets other than inventory or consumer goods

181. The law should provide that an acquisition security right in proceeds of tangible assets other than inventory or consumer goods has the same priority as the acquisition security right in those assets.

Priority of a security right in proceeds of inventory

182. The law should provide that a security right in proceeds of inventory has the same priority as the acquisition security right in that inventory, except where the proceeds take the form of receivables, negotiable instruments, rights to payment of funds credited to a bank account or rights to receive the proceeds under an independent undertaking. However, this priority is conditional on the acquisition secured creditor notifying secured creditors that, before the proceeds arise, registered a notice with respect to a security right in assets of the same kind as the proceeds.

[Note to the Commission: The Commission may wish to note that, to parallel the recommendation suggested in the note to recommendation 196, which does not draw a distinction between inventory and tangible assets other than inventory, an alternative to this recommendation could be added here (entitled “Priority of an acquisition security right in proceeds of a tangible asset”) along the following lines:

“The law should provide that, if an acquisition security right in tangible assets is effective against third parties, the security right in proceeds has the priority of a non-acquisition security right.”]

Acquisition security right as a security right in insolvency proceedings

183. The law should provide that, in the case of insolvency proceedings with respect to the debtor, the provisions that apply to security rights apply also to acquisition security rights.

[Note to the Commission: The Commission may wish to note that this recommendation was moved from chapter XIV on the impact of insolvency on a security right to avoid the implication that the characterization of acquisition security rights as security rights is a matter of insolvency law (an implication that would be inconsistent with the UNCITRAL Insolvency Guide; see, for example, footnote 6 to recommendation 35 of the UNCITRAL Insolvency Guide). The Commission may wish to consider deleting this recommendation and adding to recommendation 174 on the equivalence of an acquisition security right to a security right the word “insolvency”. As a result, the recommendations on security rights would apply to acquisition security rights within or outside insolvency (only the priority recommendations would be modified for acquisition security rights).]

Option B: Non-unitary approach to acquisition financing*

Purpose (non-unitary approach)

The purpose of provisions on acquisition financing, including acquisition security rights, retention-of-title rights and financial lease rights, is:

- (a) To recognize the importance and facilitate the use of acquisition financing as a source of affordable credit especially for small- and medium-sized businesses;
- (b) To provide for equal treatment of all providers of acquisition financing; and
- (c) To facilitate secured transactions in general by creating transparency with respect to acquisition financing.

Methods of acquisition financing

184. The law should provide that:

- (a) The regime of acquisition security rights in the context of the non-unitary approach is identical to that adopted in the context of the unitary approach;
- (b) All creditors, both suppliers and lenders, may acquire an acquisition security right in conformity with the regime governing acquisition security rights;
- (c) Acquisition financing based on retention-of-title rights and financial lease rights may be provided in accordance with recommendation 185; and
- (d) A lender may acquire the benefit of a retention-of-title right and a financial lease right through an assignment or subrogation.

Equivalence of a retention-of-title right and a financial lease right to an acquisition security right

185. The law should provide that the rules governing acquisition financing produce functionally equivalent economic results regardless of whether the creditor's right is a retention-of-title right, a financial lease right or an acquisition security right.

Effectiveness of a retention-of-title right and a financial lease right

186. The law should provide that a retention-of-title right or a financial lease right in a tangible asset is not effective unless the sale or lease agreement is concluded in or evidenced by a writing that in conjunction with the course of conduct between the parties indicates the seller's or the lessor's intent to retain ownership. The writing must exist not later than the time when the buyer or lessee obtains possession of the asset.

* A State may adopt option A (unitary approach to acquisition financing), i.e. recommendations 174-183, or option B (non-unitary approach to acquisition financing), i.e. recommendations 184-199.

Right of buyer or lessee to create a security right

187. The law should provide that a buyer or lessee may create a security right in a tangible asset that is the object of a retention-of-title right or a financial lease right. The security right encumbers the asset only to the extent of the asset's value in excess of the amount owing to the seller or financial lessor.

Third-party effectiveness of a retention-of-title or financial lease right in consumer goods

188. The law should provide that a retention-of-title or a financial lease right in consumer goods is effective against third parties upon conclusion of the sale or lease provided that the right is evidenced in accordance with recommendation 186.

Third-party effectiveness of a retention-of-title right in a tangible asset

189. The law should provide that:

Alternative A*

(a) A retention-of-title right or a financial lease right in tangible asset other than inventory or consumer goods is effective against third parties only if:

- (i) The seller or lessor retains possession of the asset; or
- (ii) A notice relating to the right is registered in the general security rights registry not later than [a short time period, such as 20 or 30 days, to be specified] days after the buyer or lessee obtains possession of the asset;

(b) A retention-of-title right or a financial lease right in inventory is effective against third parties only if:

- (i) The seller or lessor retains possession of the inventory; or
- (ii) Before delivery of the inventory to the buyer or lessee:
 - a. A notice relating to the right is registered in the general security rights registry; and
 - b. A secured creditor with an earlier registered non-acquisition security right created by the buyer or lessee in inventory of the same kind is notified by the seller or lessor of its intention to claim a retention-of-title right or a financial lease right. The notice should describe the inventory sufficiently to enable the secured creditor to identify the inventory that is the object of the retention-of-title right or the financial lease right;

(c) A notice sent pursuant to subparagraph (b)(ii) b. of this recommendation may cover retention-of-title rights and financial lease rights under multiple transactions between the same parties without the need to identify each transaction. The notice is effective only for rights in tangible assets of which the buyer or lessee obtains possession within a period of

* A State may adopt alternative A or alternative B of recommendation 189.

[a period of time, such as five years, to be specified] years after the notice is given.

Alternative B

a retention-of-title right or financial lease right in a tangible asset other than consumer goods is effective against third parties only if:

- (a) The seller or lessor retains possession of the asset; or
- (b) A notice relating to the right is registered in the general security rights registry not later than [a short time period, such as 20 or 30 days, to be specified] days after the buyer or lessee obtains possession of the asset.

The rule in this recommendation applies also to an acquisition security right in a tangible asset other than consumer goods.

[Note to the Commission: The Commission may wish to note that alternative A of this recommendation draws a distinction between inventory and tangible assets other than inventory, while alternative B does not draw such a distinction.]

One registration sufficient

190. The law should provide that registration of a single notice in the general security rights registry is sufficient to achieve third-party effectiveness of a retention-of-title right or a financial lease right under multiple transactions between the same parties, whether concluded before or after the registration, which involve tangible assets that fall within the description contained in the notice. The provisions on the registry system apply, with appropriate modifications as to terminology, to the registration of a retention-of-title right and a financial lease right.

Effect of failure to achieve third-party effectiveness of a retention-of-title right or a financial lease right

191. The law should provide that, if a retention-of-title right or a financial lease right is not effective against third parties, ownership of the asset as against third parties passes to the buyer or lessee, and the seller or lessor has a security right in the asset subject to the recommendations applicable to security rights.

Third-party effectiveness of a retention-of-title or financial lease right in an attachment to immovable property

192. The law should provide that a retention-of-title right or a financial lease right in a tangible asset that becomes an attachment to immovable property is effective against third parties with rights in the immovable property that are registered in the immovable property registry only if it is registered in the immovable property registry not later than [a short time period, such as 20-30 days, to be specified] days after the asset becomes an attachment.

Existence of a security right in proceeds of a tangible asset subject to a retention-of-title right or financial lease right

193. The law should provide that a seller or lessor with a retention-of-title right or financial lease right in a tangible asset has a security right in proceeds of the asset.

Third-party effectiveness of a security right in proceeds of a tangible asset subject to a retention-of-title right or financial lease right

194. The law should provide that:

(a) A security right in proceeds referred to in recommendation 193 is effective against third parties only if the proceeds are described in a generic way in the registered notice by which the retention-of-title right or financial lease right was made effective against third parties or the proceeds consist of money, receivables, negotiable instruments or rights to payment of funds credited to a bank account;

(b) If the proceeds are not described in a generic way in the registered notice or do not consist of the types of asset referred to in subparagraph (a) of this recommendation, the security right in the proceeds is effective against third parties for [a short period of time to be specified] days after the proceeds arise and continuously thereafter, if it was made effective against third parties by one of the methods referred to in recommendation 32 or 34 (chapter V on the third-party effectiveness of a security right) before the expiry of that time period.

Priority of a security right in proceeds of a tangible asset other than inventory or consumer goods

195. The law should provide that, if a retention-of-title right or financial lease right is effective against third parties, the security right in proceeds referred to in recommendation 193 has priority as against another security right in the same assets.

Priority of a security right in proceeds of inventory

196. The law should provide that, if a retention-of-title right or financial lease right is effective against third parties, the security right in proceeds of inventory referred to in recommendation 193 has the same priority as a retention-of-title or financial lease right in that inventory, except where the proceeds take the form of receivables, negotiable instruments, rights to payment of funds credited to a bank account and rights to receive the proceeds under an independent undertaking. However, this priority is conditional on the seller or lessor notifying secured creditors that have registered a notice with respect to a security right in assets of the same kind as the proceeds before the proceeds arise.

[Note to the Commission: The Commission may wish to recall that, at its fortieth session (first part), it decided that a second alternative should be prepared with respect to the third-party effectiveness of a retention-of-title right and a financial lease right that would not make a distinction between inventory and assets other than inventory as to the original encumbered assets (see A/62/17 (Part I), paras. 63 and 89-90). These alternatives are reflected in recommendation 189.]

The Commission may wish to consider whether, to parallel the alternatives in recommendation 189, an alternative to recommendations 195 and 196 should be made available (entitled “Priority of a security right in proceeds of a tangible asset”) along the following lines:

“The law should provide that, if a retention-of-title right or financial lease right in tangible assets is effective against third parties, the security right in proceeds referred to in recommendation 193 has the priority of a

non-acquisition security right if the security right in the proceeds is effective against third parties under recommendation 194.

“The law should provide that the rule in the preceding recommendation applies also to the proceeds of a tangible asset subject to an acquisition security right.”

The Commission may wish to note that these recommendations provide that the security right in the proceeds of an asset that was subject to a retention-of-title or financial lease right has the priority of a non-acquisition security right (i.e. not a super-priority). This approach, which is in line with recommendation 196, is intended to avoid a negative impact on receivables financing and inventory financing, and is consistent with the approach taken in most jurisdictions in which retention of title is used.]

Enforcement of a retention-of-title right or a financial lease right

197. The law should provide that:

(a) Rules for the post-default enforcement of a retention-of-title right or a financial lease right in a tangible asset should deal with:

- (i) The manner in which the seller or lessor may obtain possession of the asset;
- (ii) Whether the seller or lessor is required to dispose of the asset and, if so, how;
- (iii) Whether the seller or lessor may retain any surplus; and
- (iv) Whether the seller or lessor has a claim for any deficiency against the buyer or lessee;

(b) The regime that applies to the post-default enforcement of a security right applies to the post-default enforcement of a retention-of-title right or a financial lease right except to the extent necessary to preserve the coherence of the regime applicable to sale and lease.

Retention-of-title or financial lease right in insolvency proceedings

198. The law should provide that, in the case of insolvency proceedings with respect to the debtor,

Alternative A*

the provisions that apply to security rights apply also to retention-of-title rights and financial lease rights.

Alternative B

the provisions of the law of the enacting State that apply to ownership rights of third parties apply also to retention-of-title rights and financial lease rights.

[Note to the Commission: The Commission may wish to note that this recommendation was moved from chapter XIV on the impact of insolvency on a

* A State may adopt alternative A or alternative B of recommendation 198.

security right to avoid the implication that the characterization of acquisition security rights as security rights or as ownership rights is a matter of insolvency law (an implication that would be inconsistent with the UNCITRAL Insolvency Guide; see, for example, footnote 6 to recommendation 35 of the UNCITRAL Insolvency Guide).

The Commission may also wish to note that the commentary will explain that such characterization is a matter of secured transactions law or general property law. The commentary will also explain that insolvency law defers to secured transactions law on these matters. The commentary will also explain that an acquisition security right is to be treated as a security right in the context of both the unitary and the non-unitary approach.

The commentary of chapter XIV on the impact of insolvency on a security right will explain that, under the UNCITRAL Insolvency Guide, if a retention-of-title right or financial lease right is, under law other than insolvency law, a security right, the recommendations of the UNCITRAL Insolvency Guide dealing with security rights apply. If a retention-of-title right or financial lease right is, under law other than insolvency law, an ownership right, the recommendations of the UNCITRAL Insolvency Guide dealing with third-party-owned assets apply.]

Law applicable to a retention-of-title right or a financial lease right

199. The law should provide that the conflict-of-laws provisions that apply to security rights apply also to retention-of-title rights and financial lease rights.

XII. Conflict of laws*

Purpose

The purpose of conflict-of-laws provisions is to determine the law applicable to: the creation, third-party effectiveness and priority of a security right; and the pre- and post-default rights and obligations of the grantor, secured creditor and third parties.³³

A. General recommendations

Law applicable to a security right in tangible assets

200. The law³⁴ should provide that, except as provided in recommendations 201-204 and 208, the law applicable to the creation, third-party effectiveness and priority of a security right in a tangible asset is the law of the State in which the asset is located.

201. The law should provide that the law applicable to the issues mentioned in recommendation 198 with respect to a security right in a tangible asset of a type

* The recommendations on the conflict of laws were prepared in close cooperation with the Permanent Bureau of the Hague Conference on Private International Law.

³³ Conflict-of-laws issues relating to acquisition financing and insolvency are addressed in chapters XI and XIV respectively.

³⁴ "Law" in this chapter means the secured transactions law or other law in which a State may include conflict-of-laws provisions.

ordinarily used in more than one State is the law of the State in which the grantor is located.

202. The law should provide that, if a tangible asset is subject to registration in a specialized registry or notation on a title certificate providing for registration or notation of a security right, the law applicable to issues mentioned in recommendation 200 is the law of the State under whose authority the registry is maintained or the title certificate is issued.

203. The law should provide that the law applicable to the priority of a security right in a tangible asset made effective against third parties by possession of a negotiable document as against a competing security right made effective against third parties by another method is the law of the State in which the document is located.

Law applicable to a security right in tangible assets in transit or to be exported

204. The law should provide that a security right in a tangible asset (other than a negotiable instrument or a negotiable document) in transit or to be exported from the State in which it is located at the time of the creation of the security right may be created and made effective against third parties under the law of the State of the initial location of the asset as provided in recommendation 200 or under the law of the State of its ultimate destination, provided that the asset reaches that State within [a short period of time to be specified] days after the time of creation of the security right.

Law applicable to a security right in intangible assets

205. The law should provide that the law applicable to the creation, effectiveness against third parties and priority of a security right in an intangible asset is the law of the State in which the grantor is located.

Law applicable to receivables arising from a sale, lease or security agreement relating to immovable property

206. The law should provide that the law applicable to the creation, third-party effectiveness and priority of a security right in a receivable arising from a sale, lease or security agreement relating to immovable property is the law of the State in which the assignor is located. However, the law applicable to a priority conflict involving the right of a competing claimant that is registered in an immovable property registry is the law of the State under whose authority the registry is maintained. The rule in the preceding sentence applies only if registration is relevant under that law to the priority of a security right in the receivable.

Law applicable to a security right in a right to payment of funds credited to a bank account

207. The law should provide that the law applicable to the creation, third-party effectiveness, priority and enforcement of a security right in a right to payment of funds credited to a bank account, as well as rights and duties of the depositary bank with respect to the security right, is

Alternative A*

the law of the State in which the bank that maintains the bank account has its place of business. If the bank has places of business in more than one State, reference should be made to the place where the branch maintaining the account is located.

Alternative B

the law of the State expressly stated in the account agreement as the State whose law governs the account agreement or, if the account agreement expressly provides that another law is applicable to all such issues, that other law. However, the law of the State determined pursuant to the preceding sentence applies only if the depositary bank has, at the time of the conclusion of the account agreement, an office in that State that is engaged in the regular activity of maintaining bank accounts. If the applicable law is not determined pursuant to the preceding two sentences, the applicable law is to be determined pursuant to default rules based on article 5 of the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary.³⁵

This recommendation is subject to the exception provided in recommendation 208.

Law applicable to the third-party effectiveness of a security right in specified types of asset by registration

208. The law should provide that, if the State in which the grantor is located recognizes registration as a method of achieving effectiveness against third parties of a security right in a negotiable instrument or a right to payment of funds credited to a bank account, the law of the State in which the grantor is located is the law applicable to the issue whether third-party effectiveness has been achieved by registration under the laws of that State.

Law applicable to a security right in the right to receive the proceeds under an independent undertaking

209. The law should provide that the law of the State specified in an independent undertaking of a guarantor/issuer, confirmer or nominated person is the law applicable to:

- (a) The rights and duties of the guarantor/issuer, confirmer or nominated person that has received a request for an acknowledgement or that has or may pay or otherwise give value under an independent undertaking;
- (b) The right to enforce a security right in the right to receive the proceeds under the independent undertaking against the guarantor/issuer, confirmer or nominated person; and
- (c) Except as provided in recommendation 209, the third-party effectiveness and priority of a security right in the right to receive the proceeds under the independent undertaking.

* A State may adopt alternative A or alternative B of recommendation 207.

³⁵ A State that adopts alternative B has to also adopt recommendations 223 and 224.

210. If the applicable law is not specified in the independent undertaking of the guarantor/issuer or confirmer, the law applicable to the issues referred to in recommendation 209 is the law of the State of the location of the branch or office of the guarantor/issuer or confirmer indicated in the independent undertaking. However, in the case of a nominated person, the applicable law is the law of the State of the location of the nominated person's branch or office that has or may pay or otherwise give value under the independent undertaking.

211. The law should provide that the law applicable to the creation and third-party effectiveness of a security right in a receivable, negotiable instrument or other claim, the payment or other performance of which is secured by an independent undertaking, is also the law applicable to the issue whether a security right in the right to receive the proceeds under the independent undertaking is created and made effective against third parties automatically as contemplated in recommendations 25 and 48 (chapter IV on the creation of a security right).

Law applicable to a security right in proceeds

212. The law should provide that:

(a) The law applicable to the creation of a security right in proceeds is the law applicable to the creation of the security right in the original encumbered asset from which the proceeds arose; and

(b) The law applicable to the third-party effectiveness and priority of a security right in proceeds is the law applicable to the third-party effectiveness and priority of a security right in an asset of the same kind as the proceeds.

Law applicable to the rights and obligations of the grantor and the secured creditor

213. The law should provide that the law applicable to the mutual rights and obligations of the grantor and the secured creditor arising from their security agreement is the law chosen by them and, in the absence of a choice of law, by the law governing the security agreement.

Law applicable to the rights and obligations of third-party obligors and secured creditors

214. The law should provide that the law applicable to a receivable, negotiable instrument or negotiable document also is the law applicable to:

(a) The relationship between the debtor of the receivable and the assignee of the receivable, between an obligor under a negotiable instrument and the holder of a security right in the instrument or between the issuer of a negotiable document and the holder of a security right in the document;

[Note to the Commission: The Commission may wish to delete the reference to the law applicable to the relationship between the issuer of a negotiable document and the holder of a security right in the document. For the secured transactions law to provide that this relationship is subject to the law of the State governing the negotiable document may result in an inconsistency with the approaches currently taken in the transport laws of different States. The matter may be better left to other law.]

(b) The conditions under which an assignment of the receivable, a security right in the negotiable instrument or a security right in the negotiable document may be invoked against the debtor of the receivable, the obligor on the negotiable instrument or the issuer of the negotiable document (including whether an anti-assignment agreement may be asserted by the debtor of the receivable, the obligor or the issuer); and

(c) Whether the obligations of the debtor of the receivable, the obligor on the negotiable instrument or the issuer of the negotiable document have been discharged.

Law applicable to enforcement of a security right

215. The law should provide that, subject to recommendation 220, the law applicable to issues relating to the enforcement of a security right:

(a) In a tangible asset is the law of the State where enforcement takes place; and

(b) In an intangible asset is the law applicable to the priority of the security right.

Meaning of “location” of the grantor

216. The law should provide that, for the purposes of the conflict-of-laws provisions, the grantor is located in the State in which it has its place of business. If the grantor has a place of business in more than one State, the grantor’s place of business is that place where the central administration of the grantor is exercised. If the grantor does not have a place of business, reference is to be made to the habitual residence of the grantor.

Relevant time for determining location

217. The law should provide that:

(a) Except as provided in subparagraph (b) of this recommendation, references to the location of the assets or of the grantor in the conflict-of-laws provisions refer, for creation issues, to the location at the time of the putative creation of the security right and, for third-party effectiveness and priority issues, to the location at the time the issue arises;

(b) If the rights of all competing claimants in an encumbered asset were created and made effective against third parties before a change in location of the asset or the grantor, references in the conflict-of-laws provisions to the location of the asset or of the grantor refer, with respect to third-party effectiveness and priority issues, to the location prior to the change in location.

Exclusion of renvoi

218. The law should provide that a reference in the conflict-of-laws provisions to “the law” of another State as the law applicable to an issue refers to the law in force in that State other than its conflict-of-laws provisions.

Public policy and internationally mandatory rules

219. The law should provide that:

(a) The application of the law determined under the conflict-of-laws provisions may be refused only if the effects of its application would be manifestly contrary to the public policy of the forum;

(b) The conflict-of-laws provisions do not prevent the application of those provisions of the law of the forum which, irrespective of conflict-of-laws provisions, must be applied even to international situations; and

(c) Subparagraphs (a) and (b) of this recommendation do not permit the application of the provisions of the law of the forum to the third-party effectiveness and priority of a security right.

Impact of commencement of insolvency proceedings on the law applicable to security rights

220. The law should provide that the commencement of insolvency proceedings does not displace the conflict-of-laws provisions that determine the law applicable to the creation, third-party effectiveness, priority and enforcement of a security right (and, in the context of the non-unitary approach, a retention-of-title right and financial lease right). However, this provision should be subject to the effects on such issues of the application of the insolvency law of the State in which insolvency proceedings are commenced (*lex fori concursus*) to issues such as avoidance, treatment of secured creditors, ranking of claims or distribution of proceeds.³⁶

[Note to the Commission: The Commission may wish to note that this recommendation was moved from chapter XIV on the impact of insolvency on a security right and revised in order to avoid inconsistencies with the UNCITRAL Insolvency Guide, which deals with the law applicable to the validity and effectiveness of rights and claims, but not with the law applicable to the general priority or the enforcement of a security right. The commentary will explain that the first sentence of this recommendation introduces a generally acceptable conflict-of-laws rule, which is in line with the UNCITRAL Insolvency Guide as the second sentence preserves the application of the lex fori concursus.³⁷ In this context, the commentary will refer to the commentary of chapter XIV on the impact of insolvency on a security right explaining the conflict-of-laws recommendations of the UNCITRAL Insolvency Guide.]

B. Special recommendations when the applicable law is the law of a multi-unit State

221. The law should provide that in situations in which the law applicable to an issue is the law of a multi-unit State subject to recommendation 222, references to the law of a multi-unit State are to the law of the relevant territorial unit (as determined on the basis of the location of the grantor or of an encumbered asset

³⁶ See recommendation 31 of the UNCITRAL Insolvency Guide.

³⁷ See UNCITRAL Insolvency Guide, part two, para. 88, and recommendation 34, which provides that additional exceptions could be made to that principle as long as they are clearly set forth or noted in the insolvency law.

or otherwise under the conflict-of-laws provisions) and, to the extent applicable in that unit, to the law of the multi-unit State itself.

222. The law should provide that if, under its conflict-of laws provisions, the applicable law is that of a multi-unit State or one of its territorial units, the internal conflict-of laws provisions in force in the multi-unit State or territorial unit determine whether the substantive provisions of law of the multi-unit State or of a particular territorial unit of the multi-unit State apply.

223. The law should provide that, if the account holder and the depositary bank have chosen the law of a specified territorial unit of a multi-unit State as the law applicable to the account agreement:

(a) The references to “State” in the first sentence of recommendation 207 (alternative B) are to the territorial unit;

(b) The references to “that State” in the second sentence of recommendation 207 (alternative B) are to the multi-unit State itself.

224. The law should provide that the law of a territorial unit is the applicable law if:

(a) Under recommendations 207 (alternative B) and 223, the designated law is that of a territorial unit of a multi-unit State;

(b) Under the law of that State, the law of a territorial unit is the law applicable only if the depositary bank has an office within that territorial unit which satisfies the condition specified in the second sentence of recommendation 207 (alternative B); and

(c) The provision described in subparagraph (b) of this recommendation is in force at the time the security right in the bank account is created.³⁸

XIII. Transition

Purpose

The purpose of provisions on transition is to provide a fair and efficient transition to the law from the regime in force before the effective date of the law.

Effective date

225. The law should specify either a date subsequent to its enactment on which it comes into force (the “effective date”) or a mechanism by which the effective date may be determined. From its effective date, the law applies to all transactions within its scope, whether entered into before or after that date, except as provided below.

Inapplicability of the law to actions commenced before the effective date

226. The law should provide that it does not apply to a matter that is the subject of litigation or alternative binding dispute resolution proceedings that were commenced before the effective date. If enforcement of a security right has

³⁸ Only a State that adopts recommendation 207 (alternative B) needs to adopt recommendations 223 and 224.

commenced before the effective date, the enforcement may continue under the law in force before the effective date (“prior law”).

[Note to the Commission: The Commission may wish to consider whether initiation of a post-default remedy before the effective date of the new law should result in the application of the entire prior law to enforcement. If so, use of the word “must” rather than “may” is more appropriate.]

Creation of a security right

227. The law should provide that prior law determines whether a security right was created before the effective date.

Third-party effectiveness of a security right

228. The law should provide that a security right that is effective against third parties under prior law remains effective against third parties until the earlier of:

(a) The time it would cease to be effective against third parties under prior law; and

(b) The expiration of a period of [time period to be specified] months after the effective date (“the transition period”).

If the requirements for third-party effectiveness under this law are satisfied before third-party effectiveness would have ceased under the preceding sentence, third-party effectiveness is continuous.

Priority of a security right

229. Subject to recommendations 230 and 231, the law should provide that it governs the priority of a security right. The time when a security right referred to in recommendation 228 was made effective against third parties or became the subject of a registered notice under prior law is the time to be used in determining the priority of that right.

230. The law should provide that the priority of a security right is determined by prior law if:

(a) The security right and the rights of all competing claimants arose before the effective date; and

(b) The priority status of none of these rights has changed since the effective date.

231. The law should provide that the status of a security right has changed if:

(a) It was effective against third parties on the effective date in accordance with recommendation 228 and later ceased to be effective against third parties; or

(b) It was not effective against third parties on the effective date and later became effective against third parties.

[Note to the Commission: The Commission may wish to consider whether this recommendation should be deleted because it might not sufficiently explain the meaning of the word “status” and might even be misleading. The insertion of the word “priority” before the word “status” in this recommendation might be sufficient to address this matter, and the commentary could elaborate further.]

XIV. The impact of insolvency on a security right

A. *UNCITRAL Legislative Guide on Insolvency Law*:³⁹ definitions and recommendations

Definitions

12. (b) “Assets of the debtor”: property, rights and interests of the debtor, including rights and interests in property, whether or not in the possession of the debtor, tangible or intangible, movable or immovable, including the debtor’s interests in encumbered assets or in third-party-owned assets;

12. (r) “Financial contract”: any spot, forward, future, option or swap transaction involving interest rates, commodities, currencies, equities, bonds, indices or any other financial instrument, any repurchase or securities lending transaction, and any other transaction similar to any transaction referred to above entered into in financial markets and any combination of the transactions mentioned above;

[Note to the Commission: The Commission may wish to consider whether the definitions of the terms “financial contract” and “netting agreement” (drawn from United Nations Assignment Convention, article 5, subparagraphs (k) and (l) and reproduced in the Secured Transactions Guide) should also be reproduced here.]

12. (x) “*Lex fori concursus*”: the law of the State in which the insolvency proceedings are commenced;

12. (y) “*Lex rei sitae*”: the law of the State in which the asset is situated;

12. (z) “Netting”: the setting-off of monetary or non-monetary obligations under financial contracts;

12. (aa) “Netting agreement”: a form of financial contract between two or more parties that provides for one or more of the following:

(i) The net settlement of payments due in the same currency on the same date whether by novation or otherwise;

(ii) Upon the insolvency or other default by a party, the termination of all outstanding transactions at their replacement or fair market values, conversion of such sums into a single currency and netting into a single payment by one party to the other; or

(iii) The set-off of amounts calculated as set forth in subparagraph (ii) of this definition under two or more netting agreements.⁴⁰

12. (dd) “Party in interest”: any party whose rights, obligations or interests are affected by insolvency proceedings or particular matters in the insolvency proceedings, including the debtor, the insolvency representative, a creditor, an equity holder, a creditor committee, a government authority or any other person so affected. It is not intended that persons with remote or diffuse interests affected by the insolvency proceedings would be considered to be a party in interest;

³⁹ United Nations publication, E.05.V.10.

⁴⁰ United Nations Convention on the Assignment of Receivables in International Trade (United Nations publication, Sales No. E.04.V.14), article 5, subparagraph (1).

- 12. (ff) “Preference”: a transaction which results in a creditor obtaining an advantage or irregular payment;
- 12. (gg) “Priority”: the right of a claim to rank ahead of another claim where that right arises by operation of law;
- 12. (hh) “Priority claim”: a claim that will be paid before payment of general unsecured creditors;
- 12. (ii) “Protection of value”: measures directed at maintaining the economic value of encumbered assets and third-party-owned assets during the insolvency proceedings (in some jurisdictions referred to as “adequate protection”). Protection may be provided by way of cash payments, provision of security interests over alternative or additional assets or by other means as determined by a court to provide the necessary protection;
- 12. (pp) “Security interest”: a right in an asset to secure payment or other performance of one or more obligations.

Recommendations

[Note to the Commission: The Commission may wish to note that, in order to ensure that all relevant recommendations of the UNCITRAL Insolvency Guide are reproduced in this chapter, recommendations (34), (40-45), (63), (73), (79), (81)-(85), (87), (92), (146)-(149) and (178) of the UNCITRAL Insolvency Guide have been included below.]

Key objectives of an efficient and effective insolvency law

- (1) In order to establish and develop an effective insolvency law, the following key objectives should be considered:
 - (a) Provide certainty in the market to promote economic stability and growth;
 - (b) Maximize value of assets;
 - (c) Strike a balance between liquidation and reorganization;
 - (d) Ensure equitable treatment of similarly situated creditors;
 - (e) Provide for timely, efficient and impartial resolution of insolvency;
 - (f) Preserve the insolvency estate to allow equitable distribution to creditors;
 - (g) Ensure a transparent and predictable insolvency law that contains incentives for gathering and dispensing information; and
 - (h) Recognize existing creditors’ rights and establish clear rules for ranking of priority claims.
- (4) The insolvency law should specify that where a security interest is effective and enforceable under law other than the insolvency law, it will be recognized in insolvency proceedings as effective and enforceable.
- (7) In order to design an effective and efficient insolvency law, the following common features should be considered:
 - (a)-(d) ...

(e) Protection of the insolvency estate against the actions of creditors, the debtor itself and the insolvency representative, and where the protective measures apply to secured creditors, the manner in which the economic value of the security interest will be protected during the insolvency proceedings;

(f)-(r) ...

Law applicable to validity and effectiveness of rights and claims

(30) The law applicable to the validity and effectiveness of rights and claims existing at the time of the commencement of insolvency proceedings should be determined by the private international law rules of the State in which insolvency proceedings are commenced.

Law applicable in insolvency proceedings: *lex fori concursus*

(31) The insolvency law of the State in which insolvency proceedings are commenced (*lex fori concursus*) should apply to all aspects of the commencement, conduct, administration and conclusion of those insolvency proceedings and their effects. These may include, for example:

(a)-(i) ...

(j) Treatment of secured creditors;

(k)-(n) ...

(o) Ranking of claims;

(p)-(s) ...

Exceptions to the application of the law of the insolvency proceedings

...

(34) Any exceptions additional to recommendations 32 and 33 should be limited in number and be clearly set forth or noted in the insolvency law.

Assets constituting the insolvency estate

(35) The insolvency law should specify that the estate should include:

(a) Assets of the debtor,⁴¹ including the debtor's interest in encumbered assets and in third-party-owned assets;

(b) Assets acquired after commencement of the insolvency proceedings; and

(c) ...

Provisional measures⁴²

(39) The insolvency law should specify that the court may grant relief of a provisional nature, at the request of the debtor, creditors or third parties, where

⁴¹ Ownership of assets would be determined by reference to the relevant applicable law, where the term "assets" is defined broadly to include property, rights and interest of the debtor, including the debtor's rights and interests in third-party-owned assets.

⁴² These articles follow the corresponding articles of the UNCITRAL Model Law on Cross-Border Insolvency, see article 19 (see annex III of the *UNCITRAL Insolvency Guide*).

relief is needed to protect and preserve the value of the assets of the debtor⁴³ or the interests of creditors, between the time an application to commence insolvency proceedings is made and commencement of the proceedings,⁴⁴ including:

(a) Staying execution against the assets of the debtor, including actions to make security interests effective against third parties and enforcement of security interests;

(b)-(d) ...

Indemnification in connection with provisional measures

(40) The insolvency law may provide the court with the power to:

(a) Require the applicant for provisional measures to provide indemnification and, where appropriate, to pay costs or fees; or

(b) Impose sanctions in connection with an application for provisional measures.

Balance of rights between the debtor and insolvency representative

(41) The insolvency law should clearly specify the balance of the rights and obligations between the debtor and any insolvency representative appointed as a provisional measure. Between the time an application for commencement of insolvency proceedings is made and commencement of those proceedings, the debtor is entitled to continue to operate its business and to use and dispose of assets in the ordinary course of business, except to the extent restricted by the court.

Notice

(42) The insolvency law should specify that, unless the court limits or dispenses with the need to provide notice, appropriate notice is to be given to those parties in interest affected by:

(a) An application or court order for provisional measures (including an application for review and modification or termination); and

(b) A court order for additional measures applicable on commencement, unless the court limits or dispenses with the need to provide notice.

Ex parte provisional measures

(43) The insolvency law should specify that, where the debtor or other party in interest affected by a provisional measure is not given notice of the application for that provisional measure, the debtor or other party in interest affected by the provisional measures has the right, upon urgent application, to be heard promptly⁴⁵ on whether the relief should be continued.

⁴³ The reference to assets in paragraphs (a)-(c) is intended to be limited to assets that would be part of the insolvency estate once proceedings commence.

⁴⁴ The insolvency law should indicate the time of effect of an order for provisional measures, for example, at the time of the making of the order, retrospectively from the commencement of the day on which the order is made or some other specified time (see para. 44 of the *UNCITRAL Insolvency Guide*).

⁴⁵ Any time limit included in the insolvency law should be short in order to prevent the loss of value of the debtor's business.

Modification or termination of provisional measures

(44) The insolvency law should specify that the court, at its own motion or at the request of the insolvency representative, the debtor, a creditor or any other person affected by the provisional measures, may review and modify or terminate those measures.

Termination of provisional measures

(45) The insolvency law should specify that provisional measures terminate when:

- (a) An application for commencement is denied;
- (b) An order for provisional measures is successfully challenged under recommendation 43; and
- (c) The measures applicable on commencement take effect, unless the court continues the effect of the provisional measures.

Measures applicable on commencement

(46) The insolvency law should specify that, on commencement of insolvency proceedings:⁴⁶

- (a) Commencement or continuation of individual actions or proceedings⁴⁷ concerning the assets of the debtor, and the rights, obligations or liabilities of the debtor are stayed;
- (b) Actions to make security interests effective against third parties and to enforce security interests are stayed;⁴⁸
- (c) Execution or other enforcement against the assets of the estate is stayed;
- (d) The right of a counterparty to terminate any contract with the debtor is suspended;⁴⁹ and
- (e) The right to transfer, encumber or otherwise dispose of any assets of the estate is suspended.⁵⁰

⁴⁶ These measures would generally be effective as at the time of the making of the order for commencement.

⁴⁷ See UNCITRAL Model Law on Cross-Border Insolvency, article 20 (see annex III of the *UNCITRAL Insolvency Guide*). It is intended that the individual actions referred to in subparagraph (a) of recommendation 46 would also cover actions before an arbitral tribunal. It may not always be possible, however, to implement the automatic stay of arbitral proceedings, such as where the arbitration does not take place in the State but in a foreign location.

⁴⁸ If law other than the insolvency law permits those security interests to be made effective within certain specified time periods, it is desirable that the insolvency law recognize those periods and permit the interest to be made effective where the commencement of insolvency proceedings occurs before expiry of the specified time period. Where law other than the insolvency law does not include such time periods, the stay applicable on commencement would operate to prevent the security interest being made effective. (For further discussion see para. 32 of the *UNCITRAL Insolvency Guide*, and the UNCITRAL Legislative Guide on Secured Transactions.)

⁴⁹ See *UNCITRAL Insolvency Guide*, paragraphs 114-119. This recommendation is not intended to preclude the termination of a contract if the contract provides for a termination date that happens to fall after the commencement of insolvency proceedings.

⁵⁰ The limitation on the right to transfer, encumber or otherwise dispose of assets of the estate may be subject to an exception in those cases where the continued operation of the business by the

Duration of measures automatically applicable on commencement

(49) The insolvency law should specify that the measures applicable on commencement of insolvency proceedings remain effective throughout those proceedings until:

- (a) The court grants relief from the measures;⁵¹
- (b) In reorganization proceedings, a reorganization plan becomes effective;⁵²
or
- (c) In the case of secured creditors in liquidation proceedings, a fixed time period specified in the law expires,⁵³ unless it is extended by the court for a further period on a showing that:
 - (i) An extension is necessary to maximize the value of assets for the benefit of creditors; and
 - (ii) The secured creditor will be protected against diminution of the value of the encumbered asset in which it has a security interest.

Protection from diminution of the value of encumbered assets

(50) The insolvency law should specify that, upon application to the court, a secured creditor should be entitled to protection of the value of the asset in which it has a security interest. The court may grant appropriate measures of protection that may include:

- (a) Cash payments by the estate;
- (b) Provision of additional security interests; or
- (c) Such other means as the court determines.

Relief from measures applicable on commencement

(51) The insolvency law should specify that a secured creditor may request the court to grant relief from the measures applicable on commencement of insolvency proceedings on grounds that may include that:

- (a) The encumbered asset is not necessary to a prospective reorganization or sale of the debtor's business;
- (b) The value of the encumbered asset is diminishing as a result of the commencement of insolvency proceedings and the secured creditor is not protected against that diminution of value; and

debtor is authorized and the debtor can transfer, encumber or otherwise dispose of assets in the ordinary course of business.

⁵¹ Relief should be granted on the grounds included in recommendation 51 of the *UNCITRAL Insolvency Guide*.

⁵² A plan may become effective upon approval by creditors or following confirmation by the court, depending upon the requirements of the insolvency law (see *UNCITRAL Insolvency Guide*, chap. IV, paras. 54 and following).

⁵³ It is intended that the stay should apply to secured creditors only for a short period of time, such as between 30 and 60 days, and that the insolvency law should clearly state the period of application.

(c) In reorganization, a plan is not approved within any applicable time limits.

Power to use and dispose of assets of the estate

(52) The insolvency law should permit:

(a) The use and disposal of assets of the estate (including encumbered assets) in the ordinary course of business, except cash proceeds; and

(b) The use and disposal of assets of the estate (including encumbered assets) outside the ordinary course of business, subject to the requirements of recommendations 55 and 58.

Further encumbrance of encumbered assets

(53) The insolvency law should specify that encumbered assets may be further encumbered, subject to the requirements of recommendations 65-67.

Use of third-party-owned assets

(54) The insolvency law should specify that the insolvency representative may use an asset owned by a third party and in the possession of the debtor provided specified conditions are satisfied, including:

(a) The interests of the third party will be protected against diminution in the value of the asset; and

(b) The costs under the contract of continued performance of the contract and use of the asset will be paid as an administrative expense.

Ability to sell assets of the estate free and clear of encumbrances and other interests

(58) The insolvency law should permit the insolvency representative to sell assets that are encumbered or subject to other interest free and clear of that encumbrance and other interest, outside the ordinary course of business, provided that:

(a) The insolvency representative gives notice of the proposed sale to the holders of encumbrances or other interests;

(b) The holder is given the opportunity to be heard by the court where they object to the proposed sale;

(c) Relief from the stay has not been granted; and

(d) The priority of interests in the proceeds of sale of the asset is preserved.

Use of cash proceeds

(59) The insolvency law should permit the insolvency representative to use and dispose of cash proceeds if:

(a) The secured creditor with a security interest in those cash proceeds consents to such use or disposal; or

(b) The secured creditor was given notice of the proposed use or disposal and an opportunity to be heard by the court; and

(c) The interests of the secured creditor will be protected against diminution in the value of the cash proceeds.

Burdensome assets

(62) The insolvency law should permit the insolvency representative to determine the treatment of any asset that is burdensome to the estate. In particular, the insolvency law may permit the insolvency representative to relinquish a burdensome asset following the provision of notice to creditors and the opportunity for creditors to object to the proposed action, except that where a secured claim exceeds the value of the encumbered asset, and the asset is not required for a reorganization or sale of the business as a going concern, the insolvency law may permit the insolvency representative to relinquish the asset to the secured creditor without notice to other creditors.

Attracting and authorizing post-commencement finance

(63) The insolvency law should facilitate and provide incentives for post-commencement finance to be obtained by the insolvency representative where the insolvency representative determines it to be necessary for the continued operation or survival of the business of the debtor or the preservation or enhancement of the value of the estate. The insolvency law may require the court to authorize or creditors to consent to the provision of post-commencement finance.

Security for post-commencement finance

(65) The insolvency law should enable a security interest to be granted for repayment of post-commencement finance, including a security interest on an unencumbered asset, including an after-acquired asset, or a junior or lower priority security interest on an already encumbered asset of the estate.

(66) The law⁵⁴ should specify that a security interest over the assets of the estate to secure post-commencement finance does not have priority ahead of any existing security interest over the same assets unless the insolvency representative obtains the agreement of the existing secured creditor(s) or follows the procedure in recommendation 67.

(67) The insolvency law should specify that, where the existing secured creditor does not agree, the court may authorize the creation of a security interest having priority over pre-existing security interests provided specified conditions are satisfied, including:

- (a) The existing secured creditor was given the opportunity to be heard by the court;
- (b) The debtor can prove that it cannot obtain the finance in any other way; and
- (c) The interests of the existing secured creditor will be protected.⁵⁵

⁵⁴ This rule may be in a law other than the insolvency law, in which case the insolvency law should note the existence of the provision.

⁵⁵ See *UNCITRAL Insolvency Guide*, paragraphs 63-69.

Effect of conversion on post-commencement finance

(68) The insolvency law should specify that where reorganization proceedings are converted to liquidation, any priority accorded to post-commencement finance in the reorganization should continue to be recognized in the liquidation.⁵⁶

Automatic termination and acceleration clauses

(70) The insolvency law should specify that any contract clause that automatically terminates or accelerates a contract upon the occurrence of any of the following events is unenforceable as against the insolvency representative and the debtor:

(a) An application for commencement, or commencement, of insolvency proceedings;

(b) The appointment of an insolvency representative.⁵⁷

(71) The insolvency law should specify the contracts that are exempt from the operation of recommendation 70, such as financial contracts, or subject to special rules, such as labour contracts.

Continuation or rejection

(72) The insolvency law should specify that the insolvency representative may decide to continue the performance of a contract of which it is aware where continuation would be beneficial to the insolvency estate.⁵⁸ The insolvency law should specify that:

(a) The right to continue applies to the contract as a whole; and

(b) The effect of continuation is that all terms of the contract are enforceable.

(73) The insolvency law may permit the insolvency representative to decide to reject a contract.⁵⁹ The insolvency law should specify that the right to reject applies to the contract as a whole.

⁵⁶ The same order of priority may not necessarily be recognized. For example, post-commencement finance may rank in priority after administrative claims relating to the costs of the liquidation.

⁵⁷ This recommendation would apply only to those contracts where such clauses could be overridden (see commentary of the *UNCITRAL Insolvency Guide*, paras. 143-145, on exceptions) and is not intended to be exclusive, but to establish a minimum: the court should be able to examine other contractual clauses that would have the effect of terminating a contract on the occurrence of similar events.

⁵⁸ Provided the automatic stay on commencement of proceedings applies to prevent termination (pursuant to an automatic termination clause) of contracts with the debtor, all contracts should remain in place to enable the insolvency representative to consider the possibility of continuation, unless the contract has a termination date that happens to fall after the commencement of insolvency proceedings.

⁵⁹ An alternative to providing a power to reject contracts is the approach of those jurisdictions which provide that performance of a contract simply ceases unless the insolvency representative decides to continue its performance.

Continuation of contracts where the debtor is in breach

(79) The insolvency law should specify that where the debtor is in breach of a contract the insolvency representative can continue the performance of that contract, provided the breach is cured, the non-breaching counterparty is substantially returned to the economic position it was in before the breach and the estate is able to perform under the continued contract.

Performance prior to continuation or rejection

(80) The insolvency law should specify that the insolvency representative may accept or require performance from the counterparty to a contract prior to continuation or rejection of the contract. Claims of the counterparty arising from performance accepted or required by the insolvency representative prior to continuation or rejection of the contract should be payable as an administrative expense:

(a) If the counterparty has performed the contract the amount of the administrative expense should be the contractual price of the performance; or

(b) If the insolvency representative uses assets owned by a third party that are in the possession of the debtor subject to contract, that party should be protected against diminution of the value of those assets and have an administrative claim in accordance with subparagraph (a).

Damages for subsequent breach of a continued contract

(81) The insolvency law should specify that where a decision is made to continue performance of a contract, damages for the subsequent breach of that contract should be payable as an administrative expense.

Damages arising from rejection

(82) The insolvency law should specify that any damages arising from the rejection of a pre-commencement contract would be determined in accordance with applicable law and should be treated as an ordinary unsecured claim. The insolvency law may limit claims relating to the rejection of a long-term contract.

Assignment of contracts

(83) The insolvency law may specify that the insolvency representative can decide to assign a contract, notwithstanding restrictions in the contract, provided the assignment would be beneficial to the estate.

(84) Where the counterparty objects to assignment of a contract, the insolvency law may permit the court to nonetheless approve the assignment provided:

(a) The insolvency representative continues the contract;

(b) The assignee can perform the assigned contractual obligations;

(c) The counterparty is not substantially disadvantaged by the assignment;
and

(d) The debtor's breach under the contract is cured before assignment.

(85) The insolvency law may specify that, where the contract is assigned, the assignee will be substituted for the debtor as the contracting party with effect from

the date of the assignment and the estate will have no further liability under the contract.

Avoidable transactions⁶⁰

(87) The insolvency law should include provisions that apply retroactively and are designed to overturn transactions, involving the debtor or assets of the estate, and that have the effect of either reducing the value of the estate or upsetting the principle of equitable treatment of creditors. The insolvency law should specify the following types of transaction as avoidable:

(a) Transactions intended to defeat, delay or hinder the ability of creditors to collect claims where the effect of the transaction was to put assets beyond the reach of creditors or potential creditors or to otherwise prejudice the interests of creditors;

(b) Transactions where a transfer of an interest in property or the undertaking of an obligation by the debtor was a gift or was made in exchange for a nominal or less than equivalent value or for inadequate value that occurred at a time when the debtor was insolvent or as a result of which the debtor became insolvent (undervalued transactions); and

(c) Transactions involving creditors where a creditor obtained, or received the benefit of, more than its pro rata share of the debtor's assets that occurred at a time when the debtor was insolvent (preferential transactions).

Avoidance of security interests

(88) The insolvency law should specify that notwithstanding that a security interest is effective and enforceable under law other than the insolvency law, it may be subject to the avoidance provisions of insolvency law on the same grounds as other transactions.

Transactions exempt from avoidance actions

(92) The insolvency law should specify the transactions that are exempt from avoidance, including financial contracts.

Financial contracts

(103) Once the financial contracts of the debtor have been terminated, the insolvency law should permit counterparties to enforce and apply their security interest to obligations arising out of financial contracts. Financial contracts should be exempt from any stay under the insolvency law that applies to the enforcement of a security interest.

⁶⁰ The use of the word "transaction" in this section is intended to refer generally to the wide range of legal acts by which assets may be disposed of or obligations incurred including by way of a transfer, a payment, granting of a security interest, a guarantee, a loan or a release or an action to make a security interest effective against third parties and may include a composite series of transactions.

Participation by creditors

(126) The insolvency law should specify that creditors, both secured and unsecured, are entitled to participate in insolvency proceedings and identify what that participation may involve in terms of the functions that may be performed.

Right to be heard and to request review

(137) The insolvency law should specify that a party in interest has a right to be heard on any issue in the insolvency proceedings that affects its rights, obligations or interests. For example, a party in interest should be entitled:

- (a) To object to any act that requires court approval;
- (b) To request review by the court of any act for which court approval was not required or not requested; and
- (c) To request any relief available to it in insolvency proceedings.

Right of appeal⁶¹

(138) The insolvency law should specify that a party in interest may appeal from any order of the court in the insolvency proceedings that affects its rights, obligations or interests.

Voting mechanisms

(145) The insolvency law should establish a mechanism for voting on approval of the plan. The mechanism should address the creditors and equity holders who are entitled to vote on the plan; the manner in which the vote will be conducted, either at a meeting convened for that purpose or by mail or other means, including electronic means and the use of proxies; and whether or not creditors and equity holders should vote in classes according to their respective rights.

(146) The insolvency law should specify that a creditor or equity holder whose rights are modified or affected by the plan should not be bound to the terms of the plan unless that creditor or equity holder has been given the opportunity to vote on approval of the plan.

(147) The insolvency law should specify that where the plan provides that the rights of a creditor or equity holder or class of creditors or equity holders are not modified or affected by a plan, that creditor or equity holder or class of creditors or equity holders is not entitled to vote on approval of the plan.

(148) The insolvency law should specify that creditors entitled to vote on approval of the plan should be separately classified according to their respective rights and that each class should vote separately.

(149) The insolvency law should specify that all creditors and equity holders in a class should be offered the same treatment.

⁶¹ In accordance with the key objectives, the insolvency law should provide that appeals in insolvency proceedings should not have suspensive effect unless otherwise determined by the court, in order to ensure that insolvency can be addressed and resolved in an orderly, quick and efficient manner without undue disruption. Time limits for appeal should be in accordance with generally applicable law, but in insolvency need to be shorter than otherwise to avoid interrupting insolvency proceedings.

Reorganization plan**Approval by classes**

(150) Where voting on approval of the plan is conducted by reference to classes, the insolvency law should specify how the vote achieved in each class would be treated for the purposes of approval of the plan. Different approaches may be taken, including requiring approval by all classes or approval by a specified majority of the classes, but at least one class of creditors whose rights are modified or affected by the plan must approve the plan.

(151) Where the insolvency law does not require a plan to be approved by all classes, the insolvency law should address the treatment of those classes which do not vote to approve a plan that is otherwise approved by the requisite classes. That treatment should be consistent with the grounds set forth in recommendation 152.

Confirmation of an approved plan

(152) Where the insolvency law requires court confirmation of an approved plan, the insolvency law should require the court to confirm the plan if the following conditions are satisfied:

- (a) The requisite approvals have been obtained and the approval process was properly conducted;
- (b) Creditors will receive at least as much under the plan as they would have received in liquidation, unless they have specifically agreed to receive lesser treatment;
- (c) The plan does not contain provisions contrary to law;
- (d) Administrative claims and expenses will be paid in full, except to the extent that the holder of the claim or expense agrees to different treatment; and
- (e) Except to the extent that affected classes of creditors have agreed otherwise, if a class of creditors has voted against the plan, that class shall receive under the plan full recognition of its ranking under the insolvency law and the distribution to that class under the plan should conform to that ranking.

Challenges to approval (where there is no requirement for confirmation)

(153) Where a plan becomes binding on approval by creditors, without requiring confirmation by the court, the insolvency law should permit parties in interest, including the debtor, to challenge the approval of the plan. The insolvency law should specify criteria against which a challenge can be assessed, which should include:

- (a) Whether the grounds set forth in recommendation 152 are satisfied; and
- (b) Fraud, in which case the requirements of recommendation 154 should apply.

Secured claims

(172) The insolvency law should specify whether secured creditors are required to submit claims.

Unliquidated claims

(178) The insolvency law should permit unliquidated claims to be admitted provisionally, pending determination of the amount of the claim by the insolvency representative.

Valuation of secured claims

(180) The insolvency law should provide that the insolvency representative may determine the portion of a secured creditor's claim that is secured and the portion that is unsecured by valuing the encumbered asset.

Secured claims

(188) The insolvency law should specify that secured claims should be satisfied from the encumbered asset in liquidation or pursuant to a reorganization plan, subject to claims that are superior in priority to the secured claim, if any. Claims superior in priority to secured claims should be minimized and clearly set forth in the insolvency law. To the extent that the value of the encumbered asset is insufficient to satisfy the secured creditor's claim, the secured creditor may participate as an ordinary unsecured creditor.

B. Additional insolvency recommendations**Assets acquired after commencement of insolvency proceedings**

232. Except as provided in recommendation 233, the insolvency law should provide that an asset of the estate acquired after the commencement of insolvency proceedings is not subject to a security right created by the debtor before the commencement of the insolvency proceedings.

233. The insolvency law should provide that an asset of the estate acquired after the commencement of insolvency proceedings with respect to the debtor is subject to a security right created by the debtor before the commencement of the insolvency proceedings to the extent the asset is proceeds (whether cash or non-cash) of an encumbered asset that was an asset of the debtor before commencement.

Automatic termination clauses in insolvency proceedings

234. If the insolvency law provides that a contract clause that, upon the commencement of insolvency proceedings or the occurrence of another insolvency-related event, automatically terminates any obligation under a contract or accelerates the maturity of any obligation under a contract, is unenforceable as against the insolvency representative or the debtor, the insolvency law should also provide that such provision does not render unenforceable or invalidate a contract clause relieving a creditor from an obligation to make a loan or otherwise extend credit or other financial accommodations to the benefit of the debtor.

Third-party effectiveness of a security right in insolvency proceedings

235. The insolvency law should provide that, if a security right is effective against third parties at the time of the commencement of insolvency proceedings, action may be taken after the commencement of the insolvency proceedings to continue,

preserve or maintain the effectiveness against third parties of the security right to the extent and in the manner permitted under the secured transactions law.

Priority of a security right in insolvency proceedings

236. The insolvency law should provide that, if a security right is entitled to priority under law other than insolvency law, the priority continues unimpaired in insolvency proceedings except if, pursuant to insolvency law, another claim is given priority. Such exceptions should be minimal and clearly set forth in the insolvency law. This recommendation is subject to recommendation 188 of the *UNCITRAL Insolvency Guide*.

Effect of a subordination agreement in insolvency proceedings

237. The insolvency law should provide that, if a holder of a security right in an asset of the insolvency estate subordinates its priority unilaterally or by agreement in favour of any existing or future competing claimant, such subordination is binding in insolvency proceedings with respect to the debtor to the same extent that such subordination is effective under non-insolvency law.

Costs and expenses of maintaining value of the encumbered asset in insolvency proceedings

238. The insolvency law should provide that the insolvency representative is entitled to recover on a first priority basis from the value of an encumbered asset reasonable costs and expenses incurred by the insolvency representative in maintaining, preserving or increasing the value of the encumbered asset for the benefit of the secured creditor.

Valuation of encumbered assets in reorganization proceedings

239. The insolvency law should provide that, in determining the liquidation value of encumbered assets in reorganization proceedings, consideration should be given to the use of those assets and the purpose of the valuation. The liquidation value of those assets may be based on their value as part of a going concern.

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**Note by the Secretariat on terminology recommendations of the UNCITRAL draft
Legislative Guide on Secured Transactions, submitted to the Working Group on
Security Interests at its twelfth session**

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VII. Priority of a security right

A. General remarks

1. Introduction

(a) The concept of priority

1. The concept of priority is at the core of every successful secured transactions regime. It is the primary means by which States resolve conflicts among competing claimants to a debtor's property (for the definitions of the terms "priority" and "competing claimant", see Introduction, section B, Terminology). In a secured

transactions regime relating to movable assets, the concept is reflected in the set of principles and rules governing the extent to which a secured creditor may derive the economic benefit of its right in an encumbered asset in preference to any other competing claimant.

2. The logic and limits of the concept of priority are best understood against the backdrop of a State's general law of debtor-creditor relations. In some States, debtor-creditor law does not directly concern itself with the relationship among a debtor's various creditors; it only deals with the relationship between the creditor and its debtor. Upon default, a creditor can obtain a judgement against its debtor and then simply seize and sell its debtor's assets to pay the amount owed based on the judgement. In these States, the concept of priority (that is, where it is necessary to determine which of two or more claimants has the best right in an asset) arises only when a competing claimant contests a creditor's right to realize upon one or more of its debtor's assets. This might occur, for example, where a creditor seizes property found on its debtor's premises that may in fact belong to a third party.

3. In most States, however, debtor-creditor law is more broadly cast. It is also more explicit about how relationships among all of a debtor's creditors are to be regulated. Two general principles usually govern these relationships. First, the law typically provides that the assets of a debtor are the "common pledge" (sometimes known as the "sizeable estate") of its creditors: all a debtor's assets may be seized and sold to satisfy an obligation confirmed by a judgement in favour of any one creditor; however, if other creditors have also obtained a judgement and join the seizure, the proceeds of sale are used to satisfy the claims of all creditors. Second, in the event that there is not enough money generated by the sale of assets to pay all creditors in full, their claims are discounted proportionally and they are paid *pro rata* (i.e. creditors share equally in the proceeds of sale in proportion to the respective amounts of their claims).

4. Although both of the principles mentioned in the preceding paragraph are part of the law of most States, the debtor-creditor law in these States has evolved well beyond these principles so as to permit particular creditors to obtain a preference over other creditors. In other words, in most States, these two principles govern all debtor-creditor relationships only where one or more creditors have not contracted with their debtor for a preference. For example, in many States, creditors use devices such as retention-of-title or a sale with a right of redemption either to prevent certain assets from becoming part of, or to withdraw certain of a debtor's assets from, the common pledge otherwise available to all creditors. Having done so, these creditors can enhance the likelihood of receiving full payment of any obligations owed to them since they no longer have to share the economic value of those assets with competing claimants. In addition, in most States, certain creditors are authorized to obtain a preferential right in the distribution of the proceeds of a sale in realization of their claims. This preference can arise either by virtue of a legislatively determined preference (such as that often awarded to repairers of assets, unpaid sellers of assets and taxing authorities) or by entering into a contract to obtain a security right in specific assets of the debtor. In these cases, the right of certain creditors to be paid in preference to other creditors directly enhances the likelihood that the former creditors will receive full payment of their claims, since competing claimants will be paid only after the claims of preferred creditors have been fully satisfied. Sorting through the consequences of these techniques to obtain

a preference over competing claimants is one of the key purposes of rules governing priority.

5. States take different general approaches to creating a set of priority rules. In some States, the concept is given a rather narrow meaning. It is used only in reference to competitions between claimants that have obtained a preference through a disruption of the principle of creditor equality. In these States, competitions involving claimants whose claims are limited to one or more assets of the debtor (notably sellers that have retained title and subsequent acquirers of a debtor's assets) are not normally characterized as priority conflicts. They are resolved, first and foremost, by determining whether the claimant or the debtor has title to the asset in question. Moreover, in these States, questions of priority usually arise only when a creditor seeks to enforce its claim by realizing upon its debtor's assets; the concept of priority has no material relevance prior to that time.

6. In other States, the term priority has a broader scope. It is used in reference to any competition between claimants that have proprietary rights in the assets (or ostensible assets) of their debtor (even assets that the debtor may not actually yet own). For example, the conflict between a seller that has retained title to an asset, a third party to whom the debtor has purportedly sold the asset and a judgement creditor of the purchaser with a right in the asset is characterized as a priority conflict. Furthermore, in these States, the concept of priority governs the relationship between competing claimants even before a debtor is in default. A competition between the transferee of a claim and a creditor that is collecting the claim is viewed as a priority competition, even though the debtor may not yet be in default towards the collecting creditor.

7. The Guide recommends that States adopt a fully integrated (or unitary) approach to security rights as a general organizing framework. Except in connection with the non-unitary approach to acquisition financing (see chapter XI on acquisition financing), whether a creditor seeks to obtain a preference by means of either the principle of the common pledge or the principle of creditor equality, the particular means by which it does so will be a matter for secured transactions law (see chapter III, Basic approaches to security, recommendation 11). For this reason, in the present chapter the term priority is used in the broader sense just outlined. All competitions between a secured creditor and any other claimants that seek to enforce rights in an encumbered asset are treated as priority conflicts.

(b) The domain of priority: types of priority competition

8. Before examining why the concept of priority is so important (see paras. 12-16 below), the various situations in which questions of priority arise are discussed so as to explain the relevant context. Issues of priority typically arise in two main contexts, both of which presume that at least one of the competing claimants is a secured creditor.

9. Most commonly, priority issues become relevant at the point of enforcement of security rights, such as where the grantor of a security right in an encumbered asset defaults on its secured obligation, and where the value of the encumbered asset is not sufficient to satisfy the obligations owed to the enforcing creditor and all other competing claimants asserting a right in the asset. In this situation, the secured transactions law must determine how the economic value of the asset is to be

allocated among them. Often, the competing claimant will be another secured creditor of the grantor. A typical example is where a grantor has granted security rights in the same asset to two different lenders. However, in many cases, the competing claimant will be the holder of another type of proprietary right, such as a right created by statute (e.g. a preferential creditor). Still another example is where a grantor is in default to a secured creditor and an unsecured creditor of the grantor has obtained a judgement against the grantor and has taken steps to enforce the judgement against assets encumbered by the security right.

10. Priority issues also arise where a third party asserts a claim to an encumbered asset that will, if successful, enable the third party to obtain a clear title to the asset (that is, free of all security rights in the asset and other competing claims to the asset). A typical example is where a grantor creates a security right in favour of a lender retaining possession of the asset and then sells the encumbered asset to a third party. In this situation, the secured transactions law must determine whether the buyer of the asset acquires title to the asset free of the lender's security right. Another example is where a grantor creates a security right in an asset in favour of a lender and then leases or licenses the asset to a third party. Here, the secured transactions law must determine whether the lessee or licensee may each enjoy its property rights under the lease or license unaffected by the lender's security right. Yet another example arises where the insolvency representative in the grantor's insolvency proceedings claims the assets encumbered by a creditor's security right for the benefit of the insolvency estate.

11. In all of the cases just mentioned, priority is an issue only if security rights are effective against third parties (as to the distinction between effectiveness between the parties and effectiveness as against third parties, see chapter IV on the creation of a security right). While some States attach priority consequences to certain rights that may not be "fully" effective against third parties, other States draw a sharp distinction between rights that are effective against third parties and those that are not. In these States, security rights that are not effective against third parties have the same ranking, both as against each other and as against the rights of ordinary unsecured claimants. Moreover, competing claimants that benefit from a preferred status under other law (for example, providers of services such as repairers and those that are given a legislative preference) or that acquire assets from the grantor will always have priority over a security right that has not been made effective against third parties. It should be noted, however, that even if security rights are not effective against third parties and produce no priority consequences, they are, nevertheless, effective and enforceable against the grantor (see recommendation 30 and chapter VIII, Rights and obligations of the parties to a security agreement).

(c) The importance of priority rules

12. For a number of reasons, it is widely recognized that effective priority rules are fundamental to promoting the availability of secured credit.

13. To begin, the most critical issue for a secured creditor is what the priority of its security right will be in the event it seeks to enforce the security right either within or outside of the grantor's insolvency. More specifically, the question is how much might the secured creditor reasonably expect to derive from the sale of encumbered assets. This question is especially important where the encumbered assets are expected to be the creditor's primary or only source of repayment. To the

extent that the creditor is uncertain about the priority of its prospective security right at the time it is evaluating whether to extend credit, it will place less reliance on these encumbered assets as a guarantee of repayment. This uncertainty about how much can be realized upon the sale of the assets may induce the creditor to increase the cost of the credit (for example, by charging a higher interest rate) or to reduce the amount of the credit (by advancing a smaller percentage of the value of the encumbered assets). In some cases, it may even cause the creditor to refuse to extend credit altogether.

14. To minimize this uncertainty (and thereby to promote secured credit), it is important that secured transactions laws include clear priority rules that lead to predictable outcomes in any competition between claimants to the encumbered assets. In addition, because security rights have no value to secured creditors unless they are enforceable in the grantor's insolvency proceedings, it is important that these outcomes are respected by the insolvency law of a State to the maximum extent possible (see chapter XIV on the impact of insolvency on a security right, paras. 13 and 59-63). This is especially true because, in many cases, a default towards a secured creditor may be concurrent with defaults towards other creditors, triggering insolvency. Clear priority rules function not only to resolve disputes, but also to avoid disputes by enabling competing claimants to predict how a potential priority dispute will be resolved. In this way, the existence of effective priority rules can have a positive impact on the availability and cost of secured credit, by allowing prospective creditors to feel more confident that they will be able to look to the encumbered assets in the event of their grantor's default (even if the grantor becomes subject to insolvency proceedings) and to calculate accurately the risks associated with the extension of credit to a given borrower.

15. Well-conceived priority rules can also have another positive impact on the overall availability of secured credit. Many banks and other financial institutions are willing to extend credit based upon security rights that are subordinate to one or more other higher-ranking security rights held by other secured creditors, so long as they perceive that there is residual value in the grantor's assets (over and above the other secured obligations) to support their security rights and can clearly confirm the precise priority of their security rights. This presupposes that the prospective creditor is able to determine the maximum amount secured by the higher-ranking security rights, either by communicating with the holders of the other security rights or, in States that require a statement of the maximum amount for which a security right encumbers an asset, by consulting the registered notice in the general security rights registry (see para. 141 below and recommendation 57, subparagraph (d)). Alternatively, in situations where the prospective secured creditor is unable to satisfy itself that sufficient residual value exists to support the proposed new grant of credit, that secured creditor may be able to create sufficient value by negotiating a subordination agreement with one or more higher-ranking secured creditors, by which the higher-ranking creditors would subordinate their security rights in particular assets to the proposed new security right (see paras. 130-133 below and recommendation 75). The higher-ranking secured creditors may be willing to subordinate their security rights because they believe that the proposed new extension of credit will help the grantor's business, thereby enhancing the likelihood that their higher-ranking claims will be paid.

16. In both of these situations, the likelihood that another creditor will extend credit to a grantor is significantly increased in a State where there are clear priority rules that enable creditors to assess their priority with a high degree of certainty. In addition, clear and well-conceived priority rules facilitate the granting of multiple security rights in the same assets. In so doing, they enable a grantor to maximize the value of its assets that can be used to obtain credit.

(d) Outline of the chapter

17. This chapter discusses, in section A.2, general approaches to drafting priority rules, and in section A.3, the various means by which priority may be determined. The chapter then turns to a review of the key priority rules that should be part of a modern secured transactions regime. Section A.4 considers the relationship among the various competing claimants. Section A.5 addresses the scope and interpretation of priority rules. Section B reviews special priority rules that apply only to certain specific categories of assets. The chapter concludes, in section C, with a series of recommendations.

2. Approaches to drafting priority rules

18. States face a number of key policy choices when drafting priority rules. Initially, they must determine the scope of the priority regime. The first question is whether it should cover only competitions between various creditors of personal obligations or embrace competitions between all persons that claim rights in or in relation to a debtor's assets or ostensible assets. For reasons given above (see paras. 1-7), the Guide adopts the position that the priority regime should encompass priority competitions among all potential competing claimants.

19. States must then decide how these priority rules should be organized and drafted. Several approaches are possible, although they broadly reflect alternative tendencies in legislative drafting.

20. One approach is to develop priority rules as a set of general principles for courts to interpret and apply in resolving particular conflicts. When States adopt such an approach, especially in conjunction with the enactment of a new secured transactions regime of the fully integrated type that is recommended in the Guide, a tremendous burden is placed upon courts to flesh out the detailed application of these general principles. Not only must judges quickly master the underlying logic of the new regime, they must also ascertain and internalize market practices so as to develop specific rules that are predictable and efficient. Moreover, there may be a considerable period of time before a sufficient number of judicial decisions on a sufficient range of issues have been rendered so as to provide real certainty as to the operation of the priority principles in practice.

21. Another approach is to develop a large number of detailed priority rules meant to govern all the possible situations involving competing claimants that can be imagined. Where this approach is taken, especially in States that have previously developed priority regimes through broad principles derived from first determining ownership of assets subject to competing claims, a comprehensive system of specific rules can look extremely complex and difficult for lawyers and judges to use.

22. Yet another approach is to develop and organize priority rules in a coherent whole as a series of more general principles followed by specific applications of these principles to commonly occurring situations. Such an approach can provide both clarity and a high degree of certainty about any particular priority conflict. This is the approach recommended by the Guide.

23. In selecting one or the other approach, a State must consider the overall objectives it is seeking to achieve. To recall, the Guide aims to present a regime of secured transactions that envisions non-possessory security rights over a range of tangible and intangible assets that in many States have not previously been capable of being encumbered or have not been capable of being encumbered by more than one security right at a time (see recommendation 2 (a)). Moreover, the Guide takes a fully integrated approach to transactions that, regardless of their name, are intended to secure the performance of an obligation (see recommendation 11). Finally, the Guide recognizes a variety of methods by which security rights may be made effective against third parties (see recommendations 32 and 34-36). For all these reasons, the Guide recommends that States adopt the third approach to drafting their priority rules.

24. Following this logic, a modern secured transactions regime should incorporate a set of detailed and precise priority rules that: (a) are comprehensive in scope; (b) cover a broad range of existing and future secured obligations; (c) apply to all types of encumbered asset, including after-acquired assets and proceeds; and (d) provide ways for resolving priority conflicts among a wide variety of competing claimants (for example, secured creditors, transferees, service providers and judgement creditors). Such an approach to priority rules encourages prospective creditors to extend secured credit by giving them a high degree of assurance that they can predict how potential priority disputes will be resolved. The remaining sections of this chapter specify what issues these detailed rules should address and how they should be formulated.

3. Different bases upon which priority may be determined

25. In a modern secured transactions regime, because priority rules are meant to govern the rights of the holder of a security right as against the rights of one or more third parties, they are closely correlated with the different methods through which third-party effectiveness of the security right may be achieved. In view of the significant importance the Guide places on achieving third-party effectiveness, it takes the general approach that no secured creditor may assert priority over a competing claimant unless the security right has been made effective against third parties. Only in such cases can a question of priority arise.

26. This section briefly restates the various methods for achieving third-party effectiveness that have been adopted in various States, indicating in each case what basic priority principles will apply when third-party effectiveness has been achieved using that method. It reviews, in turn, third-party effectiveness deriving from: (a) registration of a notice in a general security rights registry; (b) possession of the encumbered asset by the secured creditor; (c) a control agreement; (d) registration in a specialized registry or notation on a title certificate; (e) the creation of the security right; and (f) notification to a third-party obligor.

(a) Priority where third-party effectiveness is based on registration

27. As discussed above (see chapter V on the effectiveness of a security right against third parties, paras. [...], and chapter VI on the registry system, paras. [...]), one of the most effective ways to provide creditors with the means to determine their priority with a high degree of certainty at the time they extend credit is to base priority on the use of a public registry.

28. In most States in which there is a reliable system for registration of notices with respect to security rights, the general principle is that priority is accorded to the right referred to in the earliest-registered notice (often referred to as the “first-to-register priority rule”).

(i) Registration of a notice prior to the creation of a security right

29. In many States, registration traditionally has been seen as a step to achieve third-party effectiveness that is taken once a security right has been made effective between the parties. This means that the registration publicizes and confirms a right that already exists or arises concurrently with the registration (see the discussion in chapter V on the effectiveness of a security right against third parties, paras. [...]). An example is a legal system in which a security right becomes effective against third parties when the entire security agreement is registered. In some States, however, the approach is not to register a right that already exists, but rather to register a notice relating to a right that may or may not yet exist. The registration does not confirm that the right has actually been created, but rather that it either has been created or may be created. As a result, in these States, the first-to-register priority rule can apply even if one or more of the requirements for the creation of a security right have not been satisfied at the time of registration.

30. Such an approach avoids the need for a creditor that has already registered a notice to search the registration system again after all remaining requirements for the creation of its security rights have been satisfied. It provides the creditor with certainty that, once it registers a notice of its security right, other rights with respect to which a notice is registered later in time will not have priority over its security right. For example, Creditor A can register its notice, conduct a search of the registry to determine that no notice of security right has been registered, and then extend credit with the assurance that its security right will have a first-ranking priority, even if Creditor B registers a notice of a competing security right during the period between Creditor A’s registration and Creditor A’s extension of credit. Moreover, other existing or potential creditors are also protected under this rule because the registered notice will warn them about potential security rights and they can then take steps to protect themselves (such as by requiring personal guarantees or security rights with lower-priority ranking in the same assets or higher-priority ranking security rights in other assets). This is the approach taken by the Guide (see recommendation 73 (a)).

(ii) Attenuations with respect to the first-to-register rule

31. In many States where priority is based on the first-to-register rule, that rule is attenuated in the case of what have been called “grace periods” for registration. Grace periods permit retroactivity in the third-party effectiveness of a security right if registration of a notice takes place within a short period of time following the

creation of a security right. In these cases, priority will be determined according to the date of creation rather than the date of registration of the notice. As a result, a security right that is created first but registered second may nevertheless have priority over a security right that is created second but registered first, as long as the notice with respect to the later-created security right is registered within the applicable grace period. In these cases, until the grace period expires, the registration date is not a reliable measure of a creditor's priority ranking (see generally chapter XII on acquisition financing, paras. [...]).

32. Creditors seek to protect themselves against this risk in a number of different ways. They may delay extending credit to the grantor until the applicable grace period has expired. However, this solution has the drawback that it also delays the extension of credit to the grantor. Alternatively, creditors may rely on a representation of the grantor that it has not granted any competing security rights in the same encumbered assets. This solution is also not ideal, because it provides the creditor with only a claim for damages in the event the representation is untrue. In order to avoid undermining the certainty achieved by the first-to-register rule, States generally restrict the use of grace periods to rare circumstances, such as: (a) acquisition financing; or (b) circumstances in which registration before or concurrently with creation is not logistically possible.

(iii) *Exceptions to the first-to-register rule*

33. The first-to-register rule cannot be absolute. In modern secured transactions regimes, there are two main types of exception. Sometimes States provide that a security right may be automatically effective against third parties upon its creation without the need to register a notice. This exception is most often found in respect of security rights in consumer goods (for the definition of the term "consumer goods", see Introduction, section B, Terminology). In these cases, the priority of the security right is determined by reference to the time of its creation (see paras. 45 and 46 below).

34. In addition, many States have adopted an exception to the first-to-register priority rule for security rights that have been made effective against third parties by a method other than registration of a notice in the general security rights registry. So, for example, where a notice of the security right happens to be registered second in the general registry, but has also been registered first in a specialized title registry or noted on a title certificate, States typically award priority to the order of registration in the specialized registry or to the notation on the title certificate (see paras. 41-44 below). Likewise, where a security right is registered second in the general registry, but the encumbered asset is a negotiable instrument in the possession of a creditor (see paras. 35-38 and 155-157 below), a negotiable document in possession of a creditor (see paras. 168-170 below), or a right to payment of funds credited to a bank account that has been made subject to a control agreement (see paras. 158-164 below), priority is usually given to the possessor of the negotiable instrument or negotiable document, or the beneficiary of the control agreement.

(b) **Priority where third-party effectiveness is based on possession**

35. As already discussed (see chapter IV on the creation of a security right, paras. [...], and chapter V on the effectiveness of a security right against

third parties, paras. [...]), possessory security rights traditionally have been an important component of the secured transactions laws of most States. In recognition of this fact, even in States that have established a general security rights registry, security rights in tangible assets may also be made effective against third parties through possession by the creditor.

36. In these States, notwithstanding the general principle that priority goes to the first creditor to register a notice in the general security rights registry, priority may also be established based on the date that the creditor obtained possession of the encumbered asset, without any requirement of registering a notice. Moreover, in many of these States, a third party may have actual possession of the assets, and multiple secured creditors may agree among themselves that the third party holds for all of them, with priority determined by the respective dates on which possession on behalf of each creditor is established. In such cases, possession for each of the creditors may begin on a different date, and therefore the priority among the creditors will be fixed according to the date on which possession on their account commenced. However, whenever the priority dispute is among security rights that have achieved third-party effectiveness by possession (regardless of whether possession is held by the secured creditor or by an agent on behalf of one or more secured creditors), priority generally is determined by the order in which third-party effectiveness was achieved (see recommendation 73, subparagraph (b)).

37. As a result of the use of the date of possession to establish priority, it is necessary for States to provide a rule to govern priority as among creditors that have registered a notice in the general security rights register and creditors that have obtained possession. The usual rule is that priority is determined by the order in which: (a) the notice was registered in the general security rights register; and (b) possession of the encumbered asset was obtained (see recommendation 73, subparagraph (c)). For example, if Creditor A registered a notice on Day 1, Creditor B took possession on Day 2, Creditor C arranged for Creditor B to also hold on its behalf on Day 3, and Creditor D registered a notice on Day 4, the priority ranking of the creditors would be A, B, C and D.

38. Notwithstanding its importance, priority based on possession has the disadvantage that, because possession is often not a public act, the holder of a security right that relies on possession to establish priority will have the burden of establishing precisely the time at which it obtained possession. Despite this disadvantage, however, priority based on possession is commercially useful in the case of certain assets such as negotiable instruments (e.g. a cheque, bill of exchange or promissory note) or negotiable documents of title (e.g. a bill of lading or warehouse receipt). In these cases, possession by the secured creditor can prevent prohibited dispositions of the encumbered asset by the grantor. In addition, as noted, many States also provide that a security right in these types of asset that becomes effective against third parties by possession is generally accorded priority over a security right made effective against third parties by registration of a notice, even if the registration occurs first (see recommendations 98, 105 and 106; see also paras. 155-157 and 168-170 below).

(c) Priority where third-party effectiveness is based on control

39. In some States, third-party effectiveness of a security right in certain types of intangible asset may be achieved by means of “control” (see Introduction, section B,

Terminology). In most cases where States permit third-party effectiveness to be established by control, priority is typically accorded to a secured creditor that obtains control with respect to the encumbered asset, regardless of whether that occurs before or after the rights of competing claimants in the asset arise. For example, where the asset is the right to the payment of funds credited to a bank account, the priority system generally awards priority to a security right made effective against third parties by control over a security right made effective against third parties by a different method (see recommendation 100; see also paras. 158-164 below).

40. In the case of certain types of intangible asset, such as the right to receive the proceeds under an independent undertaking, some States provide that control may be the exclusive method for achieving third-party effectiveness. Where this is the case, there is no need to provide for priority rules to govern conflicts between third-party effectiveness based on control and third-party effectiveness achieved by any other means (see recommendation 104; see also paras. 166 and 167 below).

(d) Priority where third-party effectiveness is based on registration in a specialized registry or notation on a title certificate

41. In many States, a security or other right (such as the right of a buyer or lessee of an encumbered asset) may be registered in a specialized registry, or may be noted on a title certificate. Originally, the function of some specialized registries or title notation systems was only to protect buyers of assets subject to the registry or system by confirming that the seller actually had title to the asset being sold. However, some specialized registries, such as ship and aircraft registries, traditionally have also served the broader purpose of protecting all types of transferee of rights in the designated assets, including holders of security rights. More recently, there has been a trend for specialized registries and title notation systems to cover this broader purpose (see recommendation 38).

42. When an asset is subject to a specialized registry or title notation system, the question arises as to which right of the several rights mentioned in the registry or notation system has priority. In most cases, States that have adopted such registries or systems provide that rights rank in the order in which they are registered. Such a security right has priority over a security right that is subsequently registered in the specialized registry or noted on a title certificate.

43. When a specialized registry exists, it is also necessary to determine the priority as between the right registered in the specialized registry or noted on a title certificate, on the one hand, and a right registered in the general security rights registry or a right that has been made effective against third parties by possession or some other means, on the other hand. In most such States, a right registered in a specialized registry or noted on a title certificate has priority over any security rights not so registered or noted on a title certificate. A similar rule is usually also adopted by these States in respect of transferees, lessees and licensees of rights in assets subject to a specialized registry or title notation system. With only minor exceptions, the rights of a transferee, lessee or licensee in such assets will be subordinate to any rights registered in the specialized registry or noted on the title certificate (see paras. 70-94 below and recommendation 75).

44. The reason for the approach just described is to enable transferees of such assets to enhance efficiency by permitting a person to search in only one place (i.e. the specialized registry or the title certificate). It is important to note, however, that the priority rules discussed above apply only to the extent that the specialized registration or notation regime does not itself provide for different priority rules.

(e) Priority where third-party effectiveness is based on creation of the security right

45. In States in which there is no registration system for security rights, third-party effectiveness often is automatic and is achieved upon creation of the security right. Even in States that have adopted registration systems, third-party effectiveness of rights in certain types of asset, such as consumer goods, is sometimes automatic. In these States, the priority of a security right is usually determined by comparing the time when the security right is created with the time a notice with respect to the competing security right is registered in the general security rights registry or the competing security right has been made effective against third parties by some other method (see paras. 59-61 below).

46. The advantage of and rationale for automatic third-party effectiveness is to relieve certain claimants of the need to take further steps to ensure the priority of their rights. In the case of consumer goods and assets of small value, the idea of linking priority to creation can, consequently, lead to efficient outcomes. However, there are situations where automatic third-party effectiveness can lead to inefficiencies in the priority system. For example, where States permit automatic third-party effectiveness in relation to common transactions such as retention-of-title sales and assignments of receivables for security purposes, other claimants are required to undertake costly and time-consuming inquiries (typically relying on less objective evidence such as representations of the grantor or information generally available in the market) to determine the existence and priority of non-possessory security rights.

(f) Priority where third-party effectiveness is based on notification to a third-party obligor

47. Most of the bases for determining priority noted above contemplate situations involving tangible assets such as equipment and inventory. Where security rights are created in receivables or other rights to payment, States typically provide that priority will be determined according to the date on which a notice is registered in the general security rights registry or, if some other method for achieving third-party effectiveness is at issue, the date on which third-party effectiveness is achieved. In other States, however, third-party effectiveness of a security right in a receivable and priority among competing claimants is based on the time that the debtor of the receivable is notified of the existence of the security right (for the definition of “debtor of the receivable”, see Introduction, section B, Terminology).

48. The advantage of determining priority on this basis is that it simplifies the task of the debtor of the receivable in determining to whom payment should be made. One disadvantage is that it can foster uncertainty for prospective secured creditors because they cannot know if, and when, a competing secured creditor has given notice of its security right to the debtor of the receivable. A second disadvantage is that this lack of certainty may lead claimants to immediately enforce their rights.

This result deprives the grantor of a source of income with which to operate its business.

(g) Priority legislatively determined according to the nature of the creditor's claim

49. In many States, certain claims are given a priority solely on the basis of the nature of the claim, regardless of the date on which the claim arose or was made effective against third parties. In these cases, States enact a ranking of priorities that is applicable to all competitions between claimants. For example, tax claims, claims for contributions to social welfare programmes and employee wages are sometimes given a first-ranking priority, even over security rights that have previously been made effective against third parties. Moreover, in these States, there is typically a sub-ranking under which, for example, legal costs may outrank tax claims, which may outrank claims for social welfare programmes, which in turn may outrank employee's claims for wages. Sometimes these rights require registration, and sometimes they do not. But in both cases, priority is determined according to a legislatively established ranking and not according to any scheme based on the time the security right may have been created or made effective against third parties (see paras. 95-98 below).

50. The advantage of these legislatively determined priorities is that they provide some measure of protection for claimants that might not otherwise have the negotiating power to obtain a security right by agreement. The disadvantage is that, even when they must be registered to be effective against third parties, they usually trump pre-existing security rights. In consequence, secured creditors cannot, at the time they take a security right, precisely determine the ranking or amount of the legislatively determined priorities. This uncertainty inevitably is likely to drive up the cost and reduce the availability of secured credit. In recognition of this fact, States usually limit the nature and amount of such claims (e.g. to "wages in an amount not to exceed a certain amount per employee" or "up to a certain number of months of unpaid wages").

4. Rules for determining priority as among competing claimants

51. The general principles reviewed to this point form the basic structure of a priority regime in relation to: (a) the different means by which a priority system can be organized; and (b) the scope of the priority of the security right, particularly as this relates to future obligations, after-acquired assets and proceeds. The discussion that follows focuses on the specific priority rules to govern the rights of competing claimants.

(a) Priority as among secured and unsecured creditors

52. Generally, States provide that all security rights that have been made effective against third parties have priority over the rights of unsecured creditors. It is generally accepted that giving secured creditors this priority is necessary to promote the availability of secured credit. Unsecured creditors can take other steps to protect their rights, such as charging a premium to account for their increased risk, monitoring the status of the credit, or requiring the debtor to pay interest on amounts that are past due. In addition, secured credit can increase the working capital of the grantor. Typically, advances made under a secured revolving working capital loan facility are the principal source from which a company will pay its

unsecured creditors in the ordinary course of its business (see chapter II on the scope of application and other general rules, section F, Examples of financing practices covered). The principle that secured creditors have priority over unsecured creditors is central to the approach taken by the Guide, and underlies many of its recommendations (see, for example, recommendation 81).

53. In many States, the priority afforded to secured creditors over unsecured creditors is absolute. In some States, however, it is subject to an exception in favour of judgement creditors. The holder of an unsecured claim may obtain a right in the assets of a debtor by obtaining a judgement or provisional court order against the debtor. By registering the judgement in the general security rights registry, the judgement creditor is able to convert an unsecured claim into a secured claim that ranks according to the ordinary priority rules. Other States go further and provide that where an unsecured creditor has taken the steps required under applicable law to obtain a judgement or provisional court order, the proprietary rights it asserts may actually have priority over certain claims of a pre-existing secured creditor (see recommendation 81 and paras. 99-107 below).

(b) Priority as among competing security rights in the same encumbered assets

54. One of the key features of a modern secured transactions regime is the efficiency with which it resolves priority disputes among competing security rights in the same encumbered assets. Such priority disputes may involve security rights that are all made effective against third parties by registration of a notice in the general security rights registry, security rights that are all made effective against third parties by another method, or a combination of security rights that are made effective against third parties by registration and security rights that are made effective against third parties by another method. With very few exceptions, States provide, for all the various situations about to be reviewed, that priority will be determined on a temporal basis: first in time, first in right. The following paragraphs elaborate in detail how this central principle is usually applied to particular situations.

(i) Priority as among security rights made effective by registration of a notice in the general security rights registry

55. In most States that have a general security rights registry, priority among security rights that were all made effective against third parties by registration of a notice is determined by the order in which registration occurs, regardless of the order of third-party effectiveness and even if one or more of the requirements for third-party effectiveness were not satisfied at that time. Only very limited exceptions to this principle are recognized (see paras. 63-67 below).

56. This approach may be illustrated by the following example. A Grantor applies to Bank A for a loan, to be secured by a security right in all of the Grantor's existing and future equipment (a security right that may be made effective against third parties by registration of a notice in the general security rights registry). On Day 1, Bank A conducts a search of the registry, which confirms that no other notices have been filed with respect to security rights of other creditors in the Grantor's equipment. On Day 2, Bank A enters into a security agreement with the Grantor, in which Bank A commits to make the requested secured loan. Also on Day 2, Bank A registers a notice of the security right in the general security rights registry, but it

does not make the loan to the Grantor until Day 5. Thus, the security right of Bank A was created and became effective against third parties on Day 5 (i.e. the first time when all of the requirements for creation and third-party effectiveness were satisfied). However, on Day 3, the Grantor enters into a security agreement with Bank B, providing for a loan to be made by Bank B to the Grantor to be secured by a security right in the Grantor's existing and future equipment. On the same day (Day 3) Bank B registers a notice of the security right in the general security rights registry and grants the loan to the grantor. As a result, the security right of Bank B was created and made effective against third parties on Day 3. Under the first-to-register approach described above, Bank A's security right would have priority over Bank B's security right, regardless of the fact that Bank B's security right was created and made effective against third parties before Bank A's security right.

57. The primary reasons for this approach are: (a) to encourage registration of the notice as early as possible (which puts other potential creditors on notice of the security right); and (b) to provide certainty to secured creditors by enabling them to determine, before they extend credit, the priority of their security rights as against the rights of other secured creditors. In the above example, if Bank A searches the registry on Day 2 after it registers its notice and determines that there are no other notices in the registry that cover the relevant encumbered asset, Bank A can make its loan on Day 5 knowing with certainty that its security right will have priority over any other security right in the encumbered asset that may be made effective against third parties in the future, because the priority of Bank A's security right dates back to the time of its registration. By enabling Bank A to achieve this high level of certainty, the first-to-register approach can be a significant factor in promoting secured credit. Likewise, when Bank B searches the registry it will immediately know that it will have a subordinate position should Bank A extend credit and it will consequently be able to adjust the terms and conditions of the credit it extends accordingly.

58. This certainty would not exist under an alternative approach, adopted in some States, which accords priority to the first security right to become effective against third parties (third-party effectiveness requires both creation and registration or another method). There would always be a risk that another security right could achieve third-party effectiveness, and thus priority, after Bank A or B conducts its search of the record but before it makes its loan. This risk would exist regardless of how short that time period might be. For this reason, the Guide takes the position that the priority of competing claimants in such cases should be determined by the date of registration of the notice, and not the date that the security right was either created or actually became effective as against third parties (see recommendation 73, subparagraph (a)).

(ii) *Priority as among security rights made effective against third parties by means other than registration of a notice in the general security rights registry*

59. In the case of a priority dispute among security rights made effective against third parties by means other than registration of a notice in the general security rights registry, States normally accord priority to the security right that is first made effective against third parties. This rule would apply, for example, in a situation where one security right in a particular encumbered asset was made effective against

third parties by possession and another security right in the same asset was made effective automatically upon its creation.

60. In the case of security rights achieving third-party effectiveness by possession, there is normally no need for a “first-to-obtain-possession” rule analogous to the “first-to-register” rule noted above, as typically a secured creditor would obtain possession of the encumbered asset at the same time it extends credit and not before. In some States, however, it is possible for a creditor to exercise its possession through a third party. Where this is the case, more than one secured creditor may exercise possession in such a manner, and their relative priority is determined by the order in which they establish their possession through that third party. A similar result would be reached in the unlikely case that a bank or other financial institution entered into more than one control agreement. Priority would depend on the relative dates of the agreements.

61. In each of the examples given, consistent with the principle applicable to security rights made effective against third parties by registration of a notice in the general security rights registry, the Guide takes the position that the priority of competing claimants in such cases should be determined by the date that the security right became effective as against third parties (see recommendation 73, subparagraph (b)).

(iii) *Priority as among security rights made effective against third parties by registration of a notice in the general security rights registry and security rights made effective against third parties by other means*

62. In the case of priority disputes among security rights made effective against third parties by registration of a notice in the general security rights registry and security rights made effective against third parties by other means, States normally accord priority to the first security right to be registered or made effective against third parties. This rule represents a logical extension of the first-to-register rule, using the registry as a basis for enabling secured creditors to achieve a high level of certainty with respect to the priority of their security right. As the notice may be registered before the security right is created (an outcome not possible in respect of third-party effectiveness by possession or automatic third-party effectiveness upon creation), this rule also encourages the use of the registry for making security rights effective against third parties. The Guide adopts this principle as leading to the most efficient outcomes when third-party effectiveness is achieved by different means (see recommendation 73, subparagraph (c)).

(iv) *Exceptions to the first-in-time principle for establishing priority as among competing secured creditors*

63. The above-mentioned examples of how the first-in-time principle applies to the different situations where security rights are made effective against third parties by different means are nonetheless subject to limited exceptions. These exceptions reflect special priority rules relating to certain means for achieving third-party effectiveness, or certain types of transaction or encumbered asset, and are based on policy or practical considerations relating to such transactions or assets. Of the various means for achieving third-party effectiveness already mentioned, two in particular (i.e. registration in a specialized registry and control) often lead to special priority rules.

a. Registration in a specialized registry or notation on a title certificate

64. In many States, a security or other right (such as the right of a buyer or lessee of an encumbered asset) may be registered in a specialized registry, or it may be noted on a title certificate. Most of these States provide that rights rank in the order in which they are registered or noted (e.g. that such a security right has priority over a security right that is subsequently registered in the specialized registry or noted on a title certificate). In order to protect the integrity of such registers or notation systems, the Guide adopts a similar position (see recommendation 74, subparagraph (b)).

65. When a specialized registry exists, it is also necessary to determine the priority as between the right registered in the specialized registry or noted on a title certificate, on the one hand, and a right registered in the general security rights registry or a right that has been made effective against third parties by possession or some other means, on the other hand. In most such States, a security right or other right registered in a specialized registry or noted on a title certificate is accorded priority over a security right registered in a general registry or that achieves third-party effectiveness by a method other than registration in a specialized registry or notation on a title certificate, regardless of which occurred first. Once again, in order to protect the integrity of such registries and notation systems, the Guide adopts a similar position (see recommendation 74, subparagraph (a)).

b. Control agreements

66. A second exception is usually found in States that permit third-party effectiveness of security rights in certain types of intangible asset to be achieved by control. These States provide that, where a creditor obtains third-party effectiveness of a security right by control, priority is given to that security right, regardless of whether other creditors may have achieved effectiveness against third parties of their security rights by any other means (see paras. 158-164 and 166-167 below). In view of the special nature of security rights in rights to payment, the Guide adopts a similar position (see recommendations 100 and 104).

c. Other exceptions to the first-in-time rule

67. In addition to these situations, where third-party effectiveness is achieved by special means, exceptions to the first-in-time rule also arise in respect of certain types of transaction or certain types of encumbered asset. These types of transaction or asset are: (a) acquisition security rights under both the unitary and non-unitary approach, and retention-of-title or financial lease rights under the non-unitary approach (see chapter XI on acquisition financing and recommendations 173-182 and 188-196); (b) cases in which third-party effectiveness of security rights in negotiable instruments, negotiable documents or money may be achieved by possession (see paras. 155-157, 165 and 168-170 below and recommendations 98, 99, 103, 105 and 106); (c) cases involving security rights in attachments (see paras. 115-120 below and recommendations 84-86); and (d) situations involving security rights in masses or products (see paras. 121-126 below and recommendations 87-89).

(c) Priority of rights of transferees, lessees and licensees of encumbered assets

(i) General

68. When a grantor transfers, leases or licenses tangible assets (other than negotiable instruments or negotiable documents) that are subject to existing security rights, the transferee, lessee or licensee has an interest in receiving the assets free and clear of any security right, whereas the existing secured creditor has an interest in maintaining its security right in the assets sold (subject to certain exceptions; see paras. 73-84 below). It is important that priority rules address both of these interests and that an appropriate balance be struck. If the rights of a secured creditor in particular assets are put at risk every time its grantor transfers, leases or licences them, their value as security would be severely diminished and the availability of secured credit based on their value would be jeopardized.

69. In most States, the starting point is the general principle that a transferee (including a buyer, exchanger, donee, legatee and other similar transferees), lessee or licensee of an encumbered asset takes its rights in the asset subject to an existing security right (the security right is said to encompass a “right to follow” or a *droit de suite*; see chapter V on the effectiveness of a security right against third parties; see also recommendations 31 and 76). In other words, the secured creditor may follow the asset in the hands of the buyer or other transferee, lessee or licensee. Exceptions to this general principle with respect to each of these types of transaction are discussed below.

(ii) Rights of buyers

70. As already mentioned (see chapter V on the effectiveness of a security right against third parties and chapter IV on the creation of a security right), when an encumbered asset is sold, the secured creditor retains its security right in the original encumbered asset and also obtains a security right in the proceeds of the sale (which may include cash, receivables, or even other assets in the case of transactions between barterers and exchangers (for the definition of “proceeds”, see Introduction, section B, Terminology). In this situation, a question arises as to whether the security right in proceeds should replace the security right in the encumbered asset, so that the buyer takes its rights free of the security right.

71. It is sometimes argued that the security right should be extinguished upon a sale, on the premise that the secured creditor is not harmed by a sale of the assets free of its security right so long as it retains a security right in the proceeds of the sale. However, this result would not necessarily protect the secured creditor, because proceeds are often not as valuable to the creditor as the original encumbered assets. In many instances, the proceeds may have little or no value to the creditor as security (e.g. a receivable that cannot be collected because the debtor of the receivable is not financially sound). In other instances, it might be difficult for the creditor to identify the proceeds and its claim to the proceeds may, therefore, be illusory. In addition, there is a risk that the proceeds, even if they are of value to the secured creditor, may be dissipated by the seller that receives them, leaving the creditor with nothing. Finally, it may be that another creditor may have taken a security right in the proceeds as original encumbered assets, and may have priority. This possibility is especially real in the case of receivables.

72. While States have adopted different approaches to achieving a balance between the interests of secured creditors and persons buying encumbered assets from grantors in possession, most provide that the security right should survive the transfer even when the secured creditor is also able to claim a right in proceeds. This does not mean that the secured creditor will be paid twice. As a security right secures an obligation, the secured creditor that asserts rights in the assets and in the proceeds cannot claim or receive more than it is owed. The Guide takes the position that, as a general principle, the secured creditor should retain its security right in the original encumbered asset and also a security right in the proceeds of its sale or other transfer (see recommendations 19, 31, 39, 40 and 76).

73. This said, most States recognize two exceptions to the general principle that a security right in an asset continues to encumber the asset after its sale, and the Guide does also. The first exception relates to situations in which the secured creditor expressly authorizes the sale free of the security right (see recommendation 77, subparagraph (a)). A secured creditor may authorize such a sale, for example, because it believes that the proceeds are sufficient to secure payment of the secured obligation or because the grantor gives the secured creditor other assets as security to make up for the loss of the sold asset. It should be noted, however, that this exception does not apply to situations in which the secured creditor authorizes the sale, but does not authorize the grantor to sell free of the security right. In these situations, the buyer generally takes title to the asset subject to the security right.

74. The second exception refers to situations in which the authorization by the secured creditor to sell the assets free of the security right is inferred, because the encumbered assets are of such a nature that the secured party expects them to be sold free of the security right, or where it is in the best interest of all concerned parties that they be sold free of the security right. States have framed this second exception in a number of different ways, as described in the following paragraphs.

a. The ordinary-course-of-business approach

75. A common approach, taken in many States, is to provide that sales of encumbered assets consisting of inventory made by the grantor in the ordinary course of its business will result in the automatic extinguishment of any security rights that the secured creditor has in the assets without any further action on the part of the buyer, seller or secured creditor. The corollary to this rule is that when a sale of inventory is outside the ordinary course of the grantor's business, or when the sale relates to an asset other than inventory, the exception will not apply; such a sale does not extinguish the security right and the secured creditor may, upon a default by the grantor, enforce its security right against the encumbered asset in the hands of the buyer (unless the secured creditor has authorized the sale free of the security right). Where the security agreement so provides, the sale itself may constitute a default entitling the secured creditor to enforce its security rights; otherwise, the secured creditor cannot do so until default has occurred.

76. Under this approach, two requirements must be satisfied for the encumbered asset to be sold free of the security right. The first requirement is that the seller of the asset must be in the business of selling assets of that kind; the encumbered asset cannot be something that the seller does not typically sell. In addition, the sale cannot be concluded in a manner different than the manner typically followed by the

seller, such as a sale by the seller outside of its typical distribution channel (e.g. if the seller normally sells only to retailers and the sale at issue is to a wholesaler). The second requirement is that the buyer must not have knowledge that the sale violates the rights of a secured creditor under a security agreement (for a rule of interpretation with respect to “knowledge”, see Introduction, section B, Terminology). This would be the case, for example, if a buyer had knowledge that the sale to it was prohibited by the terms of the security agreement. On the other hand, mere knowledge on the part of the buyer of the fact that the asset was subject to a security right would be insufficient.

77. The “ordinary-course-of-business” approach has the advantage that it is consistent with the commercial expectation that the grantor will sell its inventory of tangible assets (and indeed must do so to remain financially viable), and that buyers of the tangible assets will take them free and clear of existing security rights. Without such an exception to the principle that the security right continues in the asset in the hands of a buyer, a grantor’s ability to sell tangible assets in the ordinary course of its business would be greatly hampered, because buyers would have to investigate claims to the tangible assets prior to purchasing them. This situation would result in significant transaction costs and would greatly impede ordinary-course transactions.

78. The ordinary-course-of-business approach also provides a simple and transparent basis for determining whether tangible assets are sold free and clear of security rights. For example, the sale of equipment by an equipment dealer to a manufacturer that will use the equipment in its factory is clearly a sale of inventory in the ordinary course of the dealer’s business, and the buyer should automatically take the equipment free and clear of any security rights in favour of the dealer’s creditors. This result is in line with the expectations of all parties, and the buyer is certainly entitled to presume that both the seller and any secured creditor of the seller expect the sale to take place in order to generate sales revenue for the seller. Conversely, a sale by the dealer of a large number of machines in bulk to another dealer would presumably not be in the ordinary course of the dealer’s business. Similarly, a sale by a printer of old printing presses would also not be in the ordinary course of the printer’s business. In most cases, it will be obvious to the buyer, or easy for the buyer to ascertain, that the sale is in the seller’s ordinary course of business. For these reasons, the ordinary-course-of-business approach is the approach adopted by the Guide (see recommendation 78, subparagraph (a)).

79. With respect to sales that are obviously outside the ordinary course of the grantor’s business, or where there is at least a question in the mind of the buyer, as long as creditors’ security rights are subject to registration in a general security rights registry, the buyer may protect itself by searching the registry to determine whether the asset it is purchasing is subject to a security right and, if so, seek a release of the security right from the secured creditor.

80. In some jurisdictions, buyers of encumbered assets are permitted to take the assets free of the security right, even where the transaction is outside the ordinary course of the seller’s business, if the assets are low-cost items. The reason given for this approach is that, in those jurisdictions, the secured transactions law either does not permit registration of a security right in a low-cost item, or the cost of registration is high in relation to the cost of the asset and it would be unfair to impose that cost on a buyer of the item. By contrast, it may be argued that, if an

item is truly low-cost, a secured creditor is unlikely to enforce its security right against the asset in the hands of the buyer. In addition, determining which items are sufficiently low-cost to be so exempted would result in setting arbitrary limits, which would have to be continually revised to respond to cost fluctuations resulting from inflation and other factors. For these reasons, the Guide does not adopt an additional exception for low-cost items.

81. More difficult policy choices arise in the relatively uncommon situation where assets are sold several times and no sales are undertaken in the ordinary course of business of the seller. In some States, a purchaser that purchases the assets from a seller that previously purchased the assets from the grantor (a “remote purchaser”) obtains the assets free of security rights. This approach is taken because it would be difficult for a remote purchaser to detect the existence of a security right granted by a previous owner of the encumbered assets. In many instances, remote purchasers are not aware that the previous owner ever owned the asset and, accordingly, have no reason to conduct a search against the previous owner. The problem with this approach is that impairs the reliability of a security right given by a seller because of the possibility that the asset will be sold without the secured creditor’s knowledge to a remote purchaser, either innocently or with the specific intention of stripping away the security right. For this reason, other States provide that, where a buyer of tangible assets takes free of a security right granted by its seller, a remote purchaser will also take free of the security right. In these States, if the remote purchaser buys from a seller that purchased the asset subject to the security right, the remote purchaser will acquire the property subject to the security right, unless the remote sale is itself in the ordinary course of the seller’s business. To maintain consistency of approach in relation to ordinary-course-of-business sales, the Guide recommends that, where a buyer of tangible assets takes free of a security right granted by its seller, a remote purchaser will also take free of the security right (see recommendation 79). If the seller takes subject to the security right, the remote purchaser will also normally take subject to that right.

82. One potential disadvantage of the ordinary-course-of-business approach, particularly in international trade, arises in those limited situations where it is not clear to a buyer what activities fall within the ordinary course of the seller’s business. This said, in a normal buyer-seller relationship, it is highly likely that buyers would know the type of business in which the seller is involved and in these situations the ordinary-course-of-business approach would be consistent with the expectations of the parties. Therefore, the number of cases in which such confusion exists is limited in practice. On balance, the benefits of the ordinary-course-of-business approach outweigh its disadvantages. This approach facilitates commerce and allows secured creditors and buyers to protect their respective interests in an efficient and cost-effective manner without undermining the promotion of secured credit.

b. The good-faith approach

83. Many States have taken a different approach to determining whether a buyer of encumbered assets takes title to the assets free of a security right created by the seller. In these States, a buyer of tangible assets takes free of any security rights in the tangible assets if the buyer purchases the tangible assets in good faith (without regard to whether the sale was in the ordinary course of business of the seller).

States have adopted various formulations of the definition of “good faith” for the purposes of this test. For example, in some States the buyer is under a duty to investigate whether the assets are subject to a security right, while in other States the buyer is not under such a duty.

84. One argument in favour of this approach is that good faith is a notion known to all legal systems and there exists significant experience with its application at both the national and international levels. Another argument is that a presumption should exist that a buyer is acting in good faith unless it is proven otherwise. Yet another argument in favour of this approach is that it relieves the buyer of the cost and time involved in conducting a search of the registry. However, the problem with such an approach is that it focuses on a subjective criterion relating to the knowledge and intentions of the buyer (which also raise difficult evidentiary issues), rather than on the commercial expectations of all parties involved in the transaction.

(iii) *Rights of lessees*

85. Priority disputes sometimes arise between the holder of a security right in a tangible asset granted by the owner or lessor of the asset and a lessee of such asset. In this context, the issue is not whether the lessee actually takes the asset free of the security right in the sense that the security right is cut off. Rather, the issue is whether the lessee’s right to use the leased asset on the terms and conditions set forth in the lease agreement are unaffected by the security right. The key point is whether, once the holder of a security right commences enforcement, the lessee can nevertheless continue using the asset so long as it continues to pay rent and otherwise abides by the terms of the lease. The general principle discussed in relation to buyers applies here as well (see paras. 70-72 above). The asset is, in principle, subject to the security right and thus the secured creditor may enforce its security right upon default of the grantor, even if this means interrupting the use of the asset by the lessee pursuant to the lease.

86. As in the case of buyers of tangible assets subject to a pre-existing security right, many States recognize two exceptions to this general principle. Under either exception, the security right does not cease to exist. However, for the duration of the lease, the right of the secured creditor is limited to the lessor-grantor’s own rights in the assets and the lessee may continue to enjoy uninterrupted use of the asset in accordance with the terms of the lease.

87. The first exception is where the secured creditor has authorized the grantor to enter into the lease unaffected by the security right. As in the case of sales of tangible assets, when a secured creditor has authorized the lease, the lessee’s knowledge of the security right is irrelevant. The Guide adopts this exception (see recommendation 77, subparagraph (b)). The second exception relates to situations in which the lessor of the tangible asset is in the business of leasing tangible assets of that type, the lease is entered into in the ordinary course of the lessor’s business and the lessee has no actual knowledge that the lease violates the rights of the secured creditor under the security agreement. Such knowledge would exist if, for example, the lessee knew that the security agreement creating such security right specifically prohibited the grantor from leasing the assets. However, the mere knowledge of the existence of the security right, whether arising because the lessee saw a notice registered in the security registration system or in another way, would not be sufficient to defeat the rights of the lessee. This exception is

based on similar policy considerations to those relating to the analogous exception for sales of tangible assets in the ordinary course of the seller's business and is the approach adopted in the Guide (see recommendation 78, subparagraph (b), and para. 73 above).

88. An effective secured transactions regime must also address the issue of a sub-lease. In situations in which the rights of a lessee of a tangible asset are deemed to be unaffected by a security right in the assets granted by the lessor, it is generally considered appropriate that the rights of a sub-lessee will also be unaffected. To maintain consistency of approach in relation to ordinary-course-of-business transactions, the Guide recommends that such a rule also apply to sub-leases (see recommendation 79).

(iv) *Rights of licensees*

89. The same issues discussed above also arise in the context of licensing of intangible assets that are subject to a security right created by the licensor and the general principle applicable to sales and leases of tangible assets also applies to licences of intangible assets (see recommendation 76). Thus, if a security right in an intangible asset is effective against third parties, it will continue in the assets in the hands of the licensee unless one of the exceptions mentioned below applies (see recommendations 77 and 78).

90. The first exception recognized by most States has two branches that track the rule in relation to sales and leases of tangible assets. Analogous to leases, where the secured creditor has authorized the licence, the licensee takes free of the security right and it is irrelevant whether the licensee knew of the security right. The Guide adopts this exception (see recommendation 77, subparagraph (b)).

91. The second exception (also analogous to similar exceptions for sales and leases of tangible assets) is a situation involving a non-exclusive licensing of intangible assets, where the licensor is in the business of granting non-exclusive licences of such assets, the licence is entered into in the ordinary course of the licensor's business, and the licensee had no knowledge that the licence violated the rights of the secured creditor under the security agreement (see recommendation 78, subparagraph (c)). As in the case of sales and leases of tangible assets, it is generally recognized that such knowledge would exist if, for example, the licensee knew that the security agreement creating such security right specifically prohibited the grantor from licensing the assets. However, the mere knowledge of the existence of the security right, as evidenced by a notice registered in the security registration system, would not be sufficient to defeat the rights of the licensee.

92. It is important to note that this second exception relates only to non-exclusive licences of intangible assets (e.g. licences under which the licensee is not the sole and exclusive licensee of the intellectual property covered by the licence, as is the case with mass-distributed software programs) and does not apply to exclusive licences. Where a grantor is engaged in the business of licensing intangible assets, a secured creditor holding a security right in the assets normally will expect its grantor to grant non-exclusive licences of the assets in order to generate revenues. Moreover, it is not reasonable to expect the licensee under a non-exclusive licence to search the general security rights registry to ascertain the existence of security rights in the licensed assets. On the other hand, an exclusive licence of intangible

assets, under which the licensee is granted the exclusive right to use the assets throughout the world or even in a specific territory, is generally a negotiated transaction. Such a transaction is often out of the ordinary course of the licensor's business (although it also may be in the ordinary course of the licensor's business if the licensor is in the business of negotiating exclusive licences as is often the case, for example, in the motion picture industry). In the case of an exclusive licence, it is reasonable to expect the licensee to search the general security rights registry to determine if the licensed assets are subject to a security right created by the licensor, and to obtain an appropriate waiver or subordination of priority.

93. Finally, as in the case of sales and leases of tangible assets, a secured transactions regime must address the case of sub-licensees. And, as with sales and leases, a strong argument exists in favour of ensuring that a sub-licensee is unaffected by a security right created by the original licensor in those situations where the law deems the licence itself to be unaffected by the security right (see recommendation 79).

(v) *Rights of donees and other gratuitous transferees*

94. The position of a recipient of an encumbered asset as a gift (i.e. without value; typically a "donee" but also a "legatee") is somewhat different from that of a buyer or other transferee for value. As the gratuitous transferee has not parted with value, there is no objective evidence of detrimental reliance on the grantor's apparently unencumbered ownership. As a result, in a priority dispute between the donee of an asset and the holder of a security right in the asset granted by the transferor, a strong argument exists in favour of awarding priority to the secured creditor, even in circumstances where the security right was not otherwise effective against third parties. A second argument in favour of this approach is that, where an encumbered asset is the subject of a gift, there are no "proceeds" to which the secured creditor may look as substitute encumbered assets. While some States take this approach, most States follow the general rule that only security rights that have been made effective against third parties will have priority over other claimants. This means that a security right that is effective against third parties follows the asset in the hands of a transferee (see recommendation 76) and exceptions are made only for transferees for value, such as buyers, lessees or licensees (see recommendations 77-79). Applying this rule, a donee could never be a transferee in the ordinary course of business and would take free of a security right only if that security right were not effective against third parties.

(d) **Priority of preferential claims**

95. In many States, as a means of achieving general social goals, certain unsecured claims are re-characterized as preferential claims and given priority, within or even outside insolvency proceedings, over other unsecured claims. In some cases, the priority also extends to secured claims, including secured claims previously registered. For example, in some States the claims of employees for unpaid wages and of the State for unpaid taxes are given priority over previously existing security rights. As social goals differ from jurisdiction to jurisdiction, the precise nature of these claims and the extent to which they are afforded priority are quite variable. Moreover, in many States, at least some of these claims must be registered in order

to be effective against third parties, while other States do not require registration for third-party effectiveness.

96. The advantage of establishing these preferential claims is that a social goal may be furthered. The possible disadvantage depends, in large part, on whether the claims are required to be registered. The disadvantage of unregistered preferential claims is that it will typically be difficult or impossible for prospective creditors to know whether such claims exist, a circumstance that increases uncertainty and thereby discourages secured credit. This particular disadvantage does not affect claims that have to be registered. Nonetheless, even registered preferential claims can adversely affect the availability and cost of secured credit. The reason is that, as such claims diminish the economic value of an asset to a secured creditor, creditors will often shift the economic burden of such claims to the grantor by increasing the interest rate or by withholding the estimated amount of such claims from the available credit.

97. To avoid discouraging secured credit, many States have recently cut back on the number of preferential claims that are given priority over existing security rights. The trend in modern legislation is to establish such claims only when there is no other effective means of satisfying the underlying social objective. For example, in some jurisdictions, tax revenue is protected through incentives for company directors to address financial problems quickly or face personal liability, while wage claims are protected through a public fund. In addition, many States have also sought to limit the impact of preferential claims on the availability of secured credit by imposing a cap either on the amount that may be paid to the preferred claimant or on the percentage of the amount realized upon enforcement that may be used to pay them.

98. If preferential claims are permitted to exist, the laws establishing them should be sufficiently clear and transparent so that a creditor is able to calculate the potential amount of the preferential claims in advance and to protect itself. Some States have achieved such clarity and transparency by listing all preferential claims in one law or in an annex to the law. Other States have achieved this result by requiring that preferential claims be registered in a public registry and by according priority to such claims only over security rights registered thereafter. When States adopt this second approach, however, much of the rationale for preferential claims disappears. This is because a number of these claims arise immediately prior to insolvency proceedings and therefore there is unlikely to be any secured credit arising after they are registered. The Guide seeks to achieve a balance with respect to preferential claims, not by recommending their registration, but rather by recommending that the law should limit such claims, both in type and amount, and that, to the extent preferential claims exist, they should be described in the law in a manner that is sufficiently clear and specific, to enable prospective secured creditors to evaluate whether or not to extend credit to a grantor (see recommendation 80).

(e) Priority of rights of judgement creditors

99. In contemporary secured transactions regimes, the general rule is that a security right that is effective against third parties is accorded priority over the rights of an unsecured creditor. However, as discussed in paragraph [...] above, in some States the holder of an unsecured claim may obtain a right in the assets of a debtor by obtaining a judgement or provisional court order against the debtor and

registering the judgement or provisional court order in the general security rights registry, thereby converting an unsecured claim into a secured claim that ranks according to the ordinary priority rules. Some of these States go further and provide that, where an unsecured creditor has taken the steps required under applicable law to obtain a judgement or provisional court order, the proprietary rights it asserts may actually have priority over certain claims of a pre-existing secured creditor. The law distinguishes these creditors from other unsecured creditors because of their diligence in doing whatever they could do, often at significant cost, to pursue their claim against their obligor. For ease of reference, the term “judgement” is used below to refer to both a judgement and a provisional court order, and the term “judgement creditor” is used to refer to a creditor that has obtained either a judgement or a provisional court order against a debtor.

100. This result is not unfair to other general unsecured creditors because they have the same rights to reduce their claims to judgement but have not taken the time or incurred the expense to do so. However, to avoid giving judgement creditors excessive powers in legal systems where a single creditor may even institute insolvency proceedings, insolvency laws often provide that security rights arising from judgements obtained within a specified period of time prior to the insolvency proceeding may be avoided by the insolvency representative. In various jurisdictions, the judgement creditor’s property right is extinguished or not recognized in the debtor’s insolvency proceedings.

101. Modern secured transactions regimes typically address this type of priority dispute by balancing the interests of the judgement creditor and the secured creditor. On the one hand, the judgement creditor has an interest in knowing at a given point of time whether there is sufficient value left unencumbered in the grantor’s assets for the enforcement of the judgement. On the other hand, a strong policy argument exists in favour of protecting the rights of the secured creditor, on the ground that the secured creditor expressly relied on its security right as a basis for extending credit.

102. Many States seek to achieve this balance by generally giving priority to a security right over a property right of a judgement creditor in encumbered assets, so long as the security right became effective against third parties before the judgement creditor’s property right arises. This is the general principle adopted by the Guide (see recommendation 81).

103. In States that seek to protect the rights of judgement creditors, there is typically one exception and two limitations to the general rule. Commonly, an exception to the rights of judgement creditors is created in the case of acquisition security rights in encumbered assets other than inventory or consumer goods. Priority is accorded to the acquisition security right even if it is not effective at the time the judgement creditor obtains rights in the encumbered assets, so long as the security right is made effective against third parties within the applicable grace period provided for such security rights. A contrary rule would create an unacceptable risk for providers of acquisition financing that had already extended credit prior to the time when the judgement creditor obtained its property right, and thus would discourage acquisition financing (see recommendation 179).

104. The limitations to the rule mentioned above relate to restrictions on the amount of credit given priority. The first limitation arises from the need to protect

existing secured creditors from making additional advances based on the value of assets subject to judgement rights. There should be a mechanism to put creditors on notice of the judgement rights. In many jurisdictions in which there is a registration system, this notice is provided by subjecting judgement rights to the registration system. If there is no registration system, or if judgement rights are not subject to the registration system, the judgement creditor might be required to notify the existing secured creditors of the existence of the judgement. In addition, the law may provide that the existing secured creditor's priority continues for a period of time (perhaps 45-60 days) after the judgement right is registered (or after the creditor receives notice of the judgement creditor's right in the encumbered assets), so that the creditor can take steps to protect its rights accordingly. The less time an existing secured creditor has to react to the existence of judgement rights and the less public such judgement rights are made, the more their potential existence will negatively affect the availability and cost of credit in the context of credit transactions that provide for extension of credit at various times after the conclusion of the credit agreement ("future advances").

105. The Guide recommends that secured creditors on record should be notified and that the priority of any security right is limited to credit extended by the secured creditor a certain number of days (e.g. 30-60) after the secured creditor had been notified of the existence of the judgement creditor's right (see recommendation 81, subparagraph (a)). Although this limitation imposes an obligation on the judgement creditor to notify the secured creditor, that obligation is generally not overly burdensome for the judgement creditor and relieves the secured creditor of the obligation to search frequently for judgements against the grantor (which would be a far more burdensome and costly obligation, the cost of which is almost always passed on to the grantor). The existence of the grace period is justified on the ground that it prevents the secured creditor under a revolving loan facility or other credit facility providing for future extensions of credit from having to cut off loans or other credit immediately, a circumstance that could create difficulties for a grantor or even force the grantor into insolvency.

106. The second limitation relates to future advances. The priority of a security right may be extended to advances made even after the secured creditor is notified of the judgement creditor's rights, provided the advance was irrevocably committed, prior to that notice, in a fixed amount or an amount that may be determined pursuant to a specified formula.

107. The rationale for this rule is that it would be unfair to deprive a secured creditor that has irrevocably committed to extend credit of the priority that it relied on when entering into the commitment. The contrary argument is that, under many credit facilities, the existence of a judgement would constitute an event of default, entitling the secured creditor to cease extending additional credit. However, ceasing to extend credit may not be a sufficient protection for the secured creditor and may be harmful to other parties as well. For example, the sudden loss of credit precipitated by the judgement could well force the grantor into insolvency proceedings, resulting not only in loss to the secured creditor and other creditors but also the possible destruction of the grantor's business. The Guide resolves this priority dispute in favour of the continued extension of credit under an irrevocable credit facility, in the interest of allowing the grantor to remain in business

(a circumstance that may result in the greatest chance for the grantor to pay all of its obligations) (see recommendation 81, subparagraph (b)).

(f) Priority of rights of persons providing services with respect to an encumbered asset

108. In many States, creditors that have provided services with respect to, or have added value to, tangible encumbered assets in some way, such as by storing, repairing or transporting them, are given a property right in the assets. In some States, this right can ripen into a fully formed security right that permits the service provider to enforce its claim as if it were a security right. In other States, this right is simply a right to refuse to hand over the assets to anyone seeking their delivery. Regardless of the nature of the service provider's right, in these States it may only be claimed while the assets are still in the possession of the service provider.

109. This treatment of service providers has the advantage of inducing them to continue providing services and of facilitating the maintenance and preservation of encumbered assets. In most States the right given to service providers has priority over all other rights that may be claimed in assets in their possession. In particular, this right ranks ahead of any other security right in those assets, regardless of the respective dates on which the two rights became effective against third parties. The rationale underlying this priority rule is that service providers are not professional financiers and should be relieved of searching the registry to determine the existence of competing security rights before providing services. Moreover, the rule facilitates services such as storage and repairs and other improvements that typically benefit secured creditors as well as grantors.

110. A question arises as to whether the priority given to service providers should be limited in amount or recognized only in certain circumstances. One approach is to limit priority to an amount (such as one month's rent in the case of landlords) and to recognize their priority over pre-existing security rights only where value is added which directly benefits the holders of the pre-existing security rights. This approach would have the advantage that the rights of secured creditors would not be unduly limited. It would have the disadvantage, though, that service providers that did not add value would not be protected. In addition, the amount of the value added by the service providers would need to be determined, a requirement that may add costs and create litigation.

111. Another approach is to limit the priority of service providers to the reasonable value of services provided. Such an approach would reflect a fair and efficient balance between the conflicting interests. It would ensure reasonable protection of service providers, while avoiding difficult questions of proof as to the relative value of the encumbered assets before and after the services are rendered. As the reasonable value of services is based on a calculation that can be verified comparatively and publicly, this approach also minimizes the costs associated with claiming the right. For this reason, it is the approach recommended in the Guide (see recommendation 82).

(g) Priority of a supplier's reclamation right

112. In some States, a supplier selling tangible assets on unsecured credit may, upon default or financial insolvency of the buyer (which may or may not be

accompanied by the grantor's insolvency proceedings), be given by law a right to reclaim the tangible assets from the buyer within a specified period of time, which is known as the "reclamation period". If insolvency proceedings have commenced with respect to the buyer, applicable insolvency law will determine the extent to which the rights of reclamation claimants would be stayed or otherwise affected (see recommendations 39-51 of the *UNCITRAL Insolvency Guide*).

113. An important question is whether a reclamation claim relating to specific tangible assets should have priority over a pre-existing security right in the same assets, either outside or inside the insolvency context. In other words the question is whether, if the assets of the buyer (including the assets sought to be reclaimed) are subject to a security right, the reclaimed assets should be returned to the seller free of such security right. In some States, the reclamation has a retroactive effect, placing the seller in the same position as it was prior to the sale (i.e. holding assets that were not subject to any security rights in favour of the buyer's creditors). However, in other States, the assets remain subject to the pre-existing security rights, provided that the security right has become effective against third parties before the supplier exercises its reclamation right. The rationale for this approach is that the holders of such security rights would likely have relied on the existence of the assets being reclaimed when extending credit. Also, if the reclamation rights were given priority in this situation, the response of inventory acquisition financiers often will be to reduce the amount of credit extended to the grantor by "reserving" for potential reclamation claims.

114. Where States have enacted a modern secured transaction regime of the type envisioned in the Guide, the seller is able to protect itself by obtaining an acquisition security right in the assets, and therefore the policy sought to be promoted by providing for reclamation rights can usually be achieved by other means. The Guide, consequently, recommends that reclamation rights do not have priority unless they are exercised before a competing security right has become effective against third parties (see recommendation 83).

(h) Priority of a security right in an attachment

115. Tangible assets may often become attachments to other tangible assets (whether movable, as in the case of tyres attached to road vehicles, or immovable, as in the case of ornamental fireplaces or chandeliers or furnaces attached to buildings). In these cases, there can often be conflicts between security rights created in the attachment and security rights created in the object to which the attachment is affixed. Different policy considerations come into play when determining how to determine the relative priority of these rights as between attachments to immovable property and attachments to movable assets.

(i) Priority of a security right in an attachment to immovable property

116. To the extent that a secured transactions regime permits security rights to be created in attachments to immovable property (as recommended by the Guide; see recommendation 21), it must also include rules governing the relative priority of a holder of security rights in an attachment to immovable property vis-à-vis persons that hold rights with respect to the related immovable property. A paramount consideration of such priority rules is to avoid unnecessarily disturbing well-established principles of immovable property law.

117. Such priority rules will have to address a number of different priority conflicts. The first is a conflict between a security right in an attachment (or any other right in an attachment, such as the right of a buyer or a lessee), that is created and made effective against third parties under immovable property law and a security right in the attachment that is made effective against third parties under the secured transactions regime governing movable assets. In this situation, out of deference to immovable property law, most States give priority to the right created and made effective against third parties under immovable property law. With a view to preserving the reliability of the immovable property registry, this is also the position taken in the Guide (see recommendation 84).

118. A second type of priority conflict may arise between a security right in an encumbered asset that is either an attachment to immovable property at the time the security right becomes effective against third parties or that becomes an attachment to immovable property subsequently, where the security right has been made effective against third parties by registration in the immovable property registry, and a security right (or other right, such as the right of a buyer or lessor) in the related immovable property. In these cases, priority will be determined according to the order of registration in the immovable property registry. Once again, the rationale is to preserve the reliability of the immovable property registry, a rationale that also underlies the position taken in the Guide (see recommendation 85).

119. A third type of priority conflict may arise between an acquisition security right in an encumbered asset that becomes an attachment to immovable property and an encumbrance in the immovable property. In order to promote the financing of the acquisition of attachments, the Guide recommends that priority be given to the acquisition security right in the encumbered asset that becomes an attachment (see recommendation 180; under recommendation 192, the same principle will also apply in cases where the acquisition financier in the non-unitary regime has a retention-of-title right or a financial lease right).

(ii) *Priority of a security right in an attachment to a movable asset*

120. Several types of priority conflict may arise with respect to security rights in assets that later became attachments to movable assets. One such type may arise between two security rights in assets that later became attachments to one or more movable asset. Another priority conflict may arise between a security right in an asset that later became an attachment to a movable asset and a security right in the relevant movable asset to which the attachment was attached where both have been registered in the general security rights registry. In these cases, priority may be determined in accordance with the order of registration or third-party effectiveness (see recommendation 173). A third type of priority conflict may arise between a security right in an asset that later became an attachment where that security right was made effective against third parties by registration in a specialized registry or notation on a title certificate and a security right in the related movable asset that was registered in the general security rights registry. In this case, priority is given to the former right in deference to the policy in favour of preserving the integrity of specialized registries and title-notation systems (see recommendation 74, subparagraph (a)). A fourth type of priority conflict may arise between two security rights in assets that later became attachments to one or more movable assets where both rights have been made effective against third parties by registration in a

specialized registry or notation on a title certificate. A fifth priority conflict may arise between a security right in an asset that later became an attachment and a security right in the relevant movable asset to which the attachment was attached where both rights have been made effective against third parties by registration in a specialized registry or notation on a title certificate. In these cases, priority is determined according to the time of such registration or notation (see recommendations 74, subparagraph (b), and 86).

(i) Priority of a security right in a mass or product derived from a security right in processed or commingled assets

121. Many types of tangible asset are destined to be manufactured, transformed or commingled with other tangible assets of the same kind. This circumstance gives rise to three types of potential priority contest that require special rules. These three types are: (a) contests between security rights taken in the same items of tangible assets that ultimately become commingled in a mass or product (e.g. sugar and sugar; oil and oil; grain and grain); (b) contests involving security rights in different tangible assets that ultimately become part of a mass or product (e.g. sugar and flour, fibreglass and polyester resin, cloth and dye in fabrics); and (c) contests involving a security right originally taken in separate tangible assets and a security right in the mass or product (e.g. sugar and cake, fibreglass and furniture, cloth and trousers). Each of these potential contests is discussed below.

(i) Priority of security rights in the same tangible assets that are commingled in a mass or product

122. States typically provide that non-possessory security rights in the same tangible assets that become commingled continue into the mass or product and have the same priority as against each other as they had prior to the commingling. The rationale for this rule is that the commingling of tangible assets into a mass or product should have no bearing on the respective rights of creditors with competing security rights in the separate tangible assets. As between each other, they should be in an identical position. Of course, in these cases the total amount available to satisfy the claims of these secured creditors cannot exceed the value of the tangible assets encumbered by these competing security rights immediately before they became commingled in the mass or product (see recommendation 22). The Guide recommends this principle as well (see recommendation 87).

(ii) Priority of security rights in tangible assets that become part of a mass or product

123. If security rights in different tangible assets that ultimately become part of a mass or product continue in the mass or product, the issue is how to determine the relative value of the rights that may be claimed by each creditor. States have taken many approaches to deciding this question, depending on how they decide the extent of the secured creditor's rights in the mass or product. The Guide recommends that secured creditors should be entitled to share in the aggregate maximum value of their security rights in the mass or product according to the ratio of the value of the assets encumbered by their respective security rights immediately prior to manufacture or incorporation to the value of all the components at that time (see recommendation 22). Using the example of the cake, if the value of the sugar is 2 and the flour 5, while the value of the cake when baked is 8, the creditors will

receive 2 and 5, respectively, but neither secured creditor will receive more than the amount of its secured obligation. Conversely, if the value of the sugar is 2 and the flour 5, while the value of the cake when baked is 6, the creditors will receive two-sevenths and five-sevenths of 6, respectively. Each creditor in this situation will suffer a proportional decrease.

124. It follows that in these types of case, each creditor is entitled to claim its pre-manufacture priority in the share of the final product that represents the value of the component part over which it had taken security. This means that, if the secured claim of one secured creditor is less than the value of its component part and the secured claim of another secured creditor is greater than the value of its component, the second secured creditor cannot claim a priority right in the excess value attributable to the share of the first secured creditor. To avoid these limitations, many secured creditors draft security agreements that describe the encumbered assets as including not only the component parts, but also any mass or product that is manufactured from these component parts. However, States typically follow the relative valuation formula described above for determining rights of secured creditors with security rights in different components of a mass or product, and this is also the approach recommended in the Guide (see recommendation 88).

(iii) *Priority of a security right originally taken in tangible assets as against a security right in the mass or product*

125. The third type of competition that States must resolve is that between security rights in tangible assets that become part of a mass or product and security rights taken in the mass or product itself. Generally, States take the position that the regular priority rules apply to govern these conflicts. For example, if Secured Creditor A has a security right in sugar that is the subject of a notice registered on 1 January, and Secured Creditor B has a security right in present and future cakes that is the subject of a notice registered on 1 February, Secured Creditor A will have priority, subject to the limitation, set out in recommendation 22, that its security right is limited to the value of the assets immediately before they became part of the mass or product. Conversely, if Secured Creditor A has a security right in sugar that is the subject of a notice registered on 1 February, and Secured Creditor B has a security right in present and future cakes that is the subject of a notice registered on 1 January, Secured Creditor B will have priority.

126. There is, however, one exception to this principle, which arises where the secured creditor that takes security in a component part is an acquisition financier (see chapter XI on acquisition financing). In these cases, and in keeping with the general treatment of acquisition financiers, States usually give the acquisition security right priority over all security rights in the mass or product that extend to future assets. To maintain a consistent regime promoting the availability of credit for the acquisition of tangible assets, the Guide also recommends adoption of this principle (see recommendation 89).

5. Scope and interpretation of priority rules

(a) Irrelevance of knowledge of the existence of the security right

127. One of the key features of a modern secured transactions regime is that, regardless of the basis adopted for determining priority, it will be fixed by reference

to objective facts (e.g. registration of a notice, possession, a control agreement, or a notation on a title certificate). For such a priority system to provide certainty, these objective facts must be the exclusive means for determining priority. This is why in most States that have modernized their regime of security rights the ordering of priority as established by, for example, the date of registration of a notice or creditor possession applies even if a subsequent creditor or other competing claimant acquired its rights with knowledge of an existing security right that was not then registered or otherwise effective against third parties.

128. The rationale for this rule is based on the premise that it is often difficult to prove that a person had knowledge of a particular fact at a particular time. This is especially true in the case of a corporation or other legal entity with numerous employees. Priority rules that are dependent on subjective knowledge provide opportunities to complicate dispute resolution, thereby diminishing certainty as to the priority status of secured creditors and reducing the efficiency and effectiveness of the system. While it might seem odd to give priority to a creditor that knows of a security right already created by a grantor, basing priority on the order of a publicly verifiable event through which a creditor makes its rights effective against third parties ensures certainty in the relationships between potentially competing claimants. This consideration supports the recommendation in the Guide that mere knowledge of a security right is irrelevant to the determination of priority (see recommendation 90).

129. This said, it is important to distinguish knowledge merely of the existence of a security right from knowledge that a particular transaction violates the rights of a secured creditor. For example, knowledge by a buyer of an unregistered security right will not disrupt the priority regime established for registered rights. By contrast, should the buyer know as well that the asset it acquires is being sold in contravention of the specific terms of a security agreement (e.g. a prohibition on the grantor's right to sell encumbered assets) significant legal ramifications may well follow (e.g. acquiring title to the asset subject to existing security rights; see paras. 70-72 above; see also recommendations 78, 98, subparagraph (b), 102 and 103).

(b) Freedom of contract with respect to priority: subordination

130. The priority regime in most States establishes rules that apply unless they are specifically modified by affected parties. In other words, most States provide that a secured creditor may at any time, whether unilaterally or by agreement, subordinate its security right to the right of an existing or future competing claimant. For example, Lender A, holding a first-priority security right in all existing and after-acquired assets of a grantor, may agree to permit the grantor to give a first-priority security right in a particular asset (e.g. a piece of equipment) to Lender B so that the grantor could obtain additional financing from Lender B based on the value of that asset. The recognition of the validity of subordination of security rights reflects a well-established policy (see, for example, article 25 of the United Nations Assignment Convention). Consistent with the widespread recognition of the utility of subordination agreements, the Guide recommends that they be permitted (see recommendation 91).

131. However, subordination cannot affect the rights of a competing claimant without its consent. Thus, a subordination agreement cannot adversely affect the priority of a secured creditor that is not a party to that agreement. This means that,

in those States which require creditors to indicate in the registered notice the maximum amount for which a security right is granted (see recommendation 57, subparagraph (d)), the subordination will be limited to the indicated value of the higher ranking right. So, for example, if Lender A has limited its security right to 100,000 and Lender B has security for 50,000, a subordination agreement between Lender A and Lender C that has security for 200,000 cannot operate so as to permit Lender C to claim more than 100,000 by priority over Lender B.

132. The purpose of a subordination agreement is to permit secured creditors to agree among themselves as to the most efficient allocation of priority of their rights in encumbered assets. To obtain the full benefit of these consensual allocations, it is essential that the priority afforded by a subordination agreement continue to apply in insolvency proceedings of the grantor. In some jurisdictions, such a provision already exists in the insolvency regime. In others it may be necessary to amend insolvency laws so as to empower the courts to enforce a subordination agreement and to enable insolvency representatives to deal with priority conflicts among parties to subordination agreements without risk of liability (see chapter XVI on the impact of insolvency on a security right, para. 63, and recommendation 237).

133. Subordination of security rights and other proprietary rights in encumbered assets does not mean subordination of payments prior to default. This is a matter for the general law of obligations. Normally, prior to default, and as long as the grantor continues to repay the loan or other credit received, the secured creditor is not entitled to enforce its security right and priority is not an issue. That is, as long as no fraud is being committed and in the absence of an agreement to the contrary between a grantor and a secured creditor, a grantor is not precluded from making payments on obligations secured by subordinate security rights.

(c) Impact of continuity of third-party effectiveness on priority

134. Where the third-party effectiveness of a security right may be achieved by more than one method (e.g. automatically, by registration, by possession, by control or by notation on a title certificate), a question arises as to whether a secured creditor that initially established the priority of its security right by reference to one such method should be permitted to change to another method without losing its original priority. Some States do not permit creditors to change the means by which they have achieved third-party effectiveness. As a result, in these States, it is not possible for a creditor's priority to be maintained following such a change. For example, if a creditor registers a notice in the general security rights register on Day 1, on Day 10 obtains possession of the encumbered asset and on Day 20 cancels the registration, from that time onwards the relevant time for establishing priority in these States would be Day 10, and not Day 1. If the initial method of establishing priority no longer exists, priority can only date from the time when a still-existing method for establishing priority was achieved.

135. In other States, it is possible to maintain priority even after a change in the method by which third-party effectiveness is achieved. Whether priority is maintained depends on the manner in which the different methods for achieving third-party effectiveness are integrated. In these States, the principle is that a security right will not lose its priority as long as there is no time during which the security right is not effective against third parties. For example, if a security right in an asset first becomes effective by possession and the secured creditor subsequently

registers a notice of the security right in the general security rights registry and returns possession to the grantor, the security right remains effective as against third parties and priority relates back to the time that possession was initially obtained as long as the registration precedes the creditor's surrender of possession. If, however, the secured creditor registers the notice after it surrenders possession of the asset, the priority of the security right dates only from the time that the secured creditor registers the notice. Rules providing for continuity in priority are especially important in cases where effectiveness against third parties was first established through possession and the duration of the credit extends past the point where the grantor requires the use of the encumbered asset. Consistent with its recommendations relating to continuity of third-party effectiveness (see recommendations 46 and 47), the Guide takes the position that, for the purpose of applying the temporal priority rules recommended in the Guide, priority should be maintained notwithstanding a change in the method by which it is determined (see recommendations 92 and 93).

136. It should be noted that the above-mentioned rule applies only where the temporal priority rules are applied to determine priority, and does not apply where the non-temporal rules are applied. In the latter case, a change in the mode of third-party effectiveness will affect the priority of a security right, even if third-party effectiveness is continuous. For example, if the holder of a negotiable instrument registers a notice of a security right in the instrument prior to surrendering possession, the special priority attaching to possession of the instrument will not be maintained simply through the registration. Should a second secured creditor have registered a notice before the secured creditor surrendering possession registered its notice, the second secured creditor will take priority based on its prior registration (see paras. 155-157 below; see also recommendation 98). Similarly, if a secured creditor with control with respect to a right to payment of funds credited to a bank account registers a notice of its security right and then surrenders control, the special priority attaching to control is lost. Should another secured creditor have registered a notice in the general security rights registry before the initial taking of control, once control is surrendered, that secured creditor would have priority based on its prior registration (see paras. 158-164 below; see also recommendation 100).

(d) Extent of priority: future advances, and future and contingent obligations

137. Previous chapters have addressed the fact that, in modern secured transactions regimes, a security right can secure not only obligations existing at the time the security right is created, but also future and contingent obligations as well (see chapter IV on the creation of a security right, paras. [...]; see also recommendation 16). Most States provide that the initial security right covers principal and interest as stipulated in the agreement as well as any fees and costs associated with recovery of payment.

138. As for future advances under existing credit arrangements and contingent obligations, States take different positions. Some give the same priority to future advances as to the original extension of credit, but in order for the initial priority to extend to future and contingent obligations, these States require such obligations to be determinable both as to type and amount (e.g. the agreement specifies that only future advances under a line of credit up to a maximum exposure of 100,000 be

secured). In other States, a security right may extend to all monetary and non-monetary obligations owed to the secured creditor of whatever type and in whatever amount, as long as the agreement so specifies. In these States, future and contingent obligations under the security agreement will have the same priority as the initial extension of credit.

139. The practical consequence is that a secured creditor is assured, at the time it makes a commitment to extend credit, that the priority of its security right will extend, not only to the credit it extends contemporaneously with the conclusion of the security agreement, but also to: (a) obligations that arise thereafter pursuant to the terms of the security agreement (such as future advances under a revolving credit agreement); and (b) contingent obligations that become actual obligations upon the occurrence of the contingency (such as obligations that become payable to the secured party under a guarantee). For example, in the case of a revolving credit facility under which the lender has agreed on Day 1 to make advances to the grantor from time to time for the entire one-year term of the facility secured by a security right in the grantor's assets, the security right will have the same priority for all of the advances made, regardless of whether they are made on Day 1, 35 or 265.

140. In the case of credit extended to enable a grantor to purchase tangible assets or services in instalments over time, this approach results in the entire claim being treated as coming into existence at the time when the contract for the purchase of the tangible assets or services is concluded, and not at the time of each delivery of tangible assets or rendering of services. One rationale for this approach is that it is the most cost-efficient approach, because it relieves the secured creditor of the need to determine priority each time it extends credit, a determination that typically involves additional searches for new registrations by other creditors, the execution of additional agreements and additional registrations for amounts of credit extended subsequent to the time the security right was created. Because the costs associated with these additional steps invariably are passed on to the grantor directly or reflected in an increase in the interest rate, eliminating them can reduce the cost of credit for the grantor. Another rationale for this approach is that it minimizes the risk to the grantor that subsequent extensions of credit under the security agreement will be interrupted if the secured creditor determines that a future advance does not have the same priority as the initial advances. For these reasons the Guide recommends adoption of priority rules that extend priority to future obligations (see recommendation 94).

141. The foregoing priority rules are, nonetheless, subject to two possible limitations. First, as noted, in some States where the priority of a security right extends to future extensions of credit, priority is limited to the maximum amount specified in the notice registered in a public registry with respect to the security right. The rationale for this approach is that it may encourage subordinate financing by encouraging prospective subordinate creditors to extend credit on the residual value of the encumbered assets (e.g. the value of the encumbered assets in excess of the maximum amount secured by the higher-ranking security right referred to in the registered notice) to the extent the prospective creditor is able to satisfy itself that a sufficient residual value exists (see recommendation 95). Other States do not take this approach on the basis that it might encourage secured creditors to inflate the amount mentioned in the registered notice to include an amount greater than that contemplated at the time of the security agreement to accommodate possible

unanticipated future advances (see chapter VI on the registry system, paras. [...]; see also recommendation 57, subparagraph (d)).

142. Second, the Guide recognizes that, in some circumstances, a secured creditor should not be able to assert its priority with respect to future advances against a creditor that obtains a judgement or provisional court order against the grantor and takes steps to enforce the judgement against the encumbered assets (see paras. 99-107 above; see also recommendations 81 and 94).

(e) Application of priority rules to a security right in after-acquired assets

143. As discussed in greater detail in chapter IV on the creation of a security right, in some States a security right may be created in assets that the grantor may acquire in the future (“after-acquired assets”). In these States, assuming that the description of the after-acquired assets is sufficient to identify them, a security right in these assets is obtained automatically at the time the grantor acquires them, without any additional steps being required at the time of acquisition. As a result, the costs incidental to the creation of the security right are minimized and the expectations of the parties are met. This is particularly important with respect to inventory that is continuously being acquired for resale, receivables that are continuously being collected and regenerated (see chapter II on the scope of application and other general rules, section F, Examples of financing practices covered, paras. [...]) and equipment that is periodically being replaced in the normal operation of the grantor’s business.

144. The recognition of the automatic creation of a security right in after-acquired assets raises the question as to whether priority should date from the time when the security right is first registered or becomes effective against third parties, or from the time the grantor acquires the assets. Different States address this matter in different ways. Some States adopt an approach that differentiates according to the nature of the creditor competing for priority. In these States, priority dates, as against other consensual secured creditors, from the date of registration or third-party effectiveness and, as against all other competing claimants, from the date the asset is acquired by the grantor. In other States, priority for all after-acquired assets, and as against all competing claimants, is determined by reference to the date priority was initially established.

145. It is generally accepted that the second of these approaches is more efficient and effective in promoting the availability of secured credit. Thus, modern secured transactions regimes typically specify that, in such cases, the priority of a security right extends to all encumbered assets covered by the registered notice, regardless of whether they come into existence before, at or after the time of registration. This is the approach taken by the Guide (see recommendation 96).

(f) Application of priority rules to a security right in proceeds

146. If a creditor has a security right in proceeds (for the definition of “proceeds”, see Introduction, section B, Terminology), issues will arise as to the priority of that security right as against the rights of competing claimants. Competing claimants with respect to proceeds may include, among others, another creditor of the grantor that has a security right in the proceeds and a creditor of the grantor that has obtained a right by judgement against the proceeds.

147. Assets that constitute proceeds to one secured creditor may constitute original encumbered assets to another secured creditor. For example, Creditor A may have a security right in all of the grantor's receivables by virtue of its security right in all of the grantor's existing and future inventory and the proceeds arising upon the sale or other disposition thereof; Creditor B may have a security right in all of the grantor's existing and future receivables as original encumbered assets. If the grantor later sells on credit inventory that is subject to the security right of Creditor A, both creditors have a security right in the receivables generated by the sale: Creditor A has a security right in the receivables as proceeds of the encumbered inventory, and Creditor B has a security right in the receivables as original encumbered assets.

148. The approach to priority taken in States that recognize a security right in proceeds will often differ depending on the nature of the competing claimants and the type of asset that gives rise to the proceeds. In priority disputes between holders of competing security rights, the priority rules for rights in proceeds of original encumbered assets may be derived from the priority rules applicable to rights in the original encumbered assets. Thus, the time of third-party effectiveness or the time of registration of a notice in the general security rights registry of a security right in an encumbered asset would also be the time of third-party effectiveness or registration, respectively, of a security right in the proceeds of such encumbered asset.

149. In the case of competitions between secured creditors with security rights in assets as proceeds and secured creditors with rights in these assets as original encumbered assets, some States distinguish between proceeds in the form of receivables and proceeds in the form of tangible assets (for example, tangible assets obtained in exchange). These States also typically distinguish between proceeds arising from the sale of inventory and proceeds arising from the sale of equipment. The general rule is that a secured creditor that takes security in receivables generated by the sale of inventory as original encumbered assets will have priority over a creditor claiming such receivables as proceeds, regardless of the respective dates on which their rights became effective as against third parties.

150. In other States, no distinctions as to the form of proceeds or the nature of the assets are made. The rule is that the first right in particular assets that is reflected in a registration has priority over the rights of a competing claimant. For example, if the registration of the security right in assets, the sale of which generates the proceeds, predates the registration of the security right in the proceeds as original encumbered assets, the security right in the assets giving rise to the proceeds has priority. Conversely, if a notice was registered with respect to the right in the proceeds as original encumbered assets before the competing claimant made a registration with respect to the assets giving rise to the proceeds, the security right of the creditor in the proceeds as original encumbered assets would have priority. This is the approach recommended in the Guide (see recommendation 97).

151. In cases in which the order of priority of competing rights in the originally encumbered asset is not determined by the order of registration in the general security rights registry (as is the case, for example, with acquisition financing rights that enjoy a special priority position), a separate determination will be necessary for the priority rule that would apply to proceeds (see chapter XI on acquisition financing, paras. [...]; see also recommendations 181 and 182 (unitary approach) and 194-196 (non-unitary approach)).

B. Asset-specific remarks

152. The particular priority conflicts that generally recur in connection with tangible assets have been reviewed above. The “first-in-time” principle is an efficient starting point for establishing priorities.

153. As noted, however, the principle requires adjustment in certain cases. Some adjustments involve other secured creditors (e.g. security rights in attachments or security rights in masses or products). Other adjustments involve competing claimants that are not secured creditors (e.g. transferees, lessees and licenses or insolvency representatives).

154. In addition to these adjustments resulting from the diversity of obligations being secured and the diversity of competing claimants, modern secured transactions regimes also contain a number of special priority rules that apply to particular types of asset and flow from the particular means for achieving third-party effectiveness applicable to these types of asset. This section deals with priority issues relating to such types of asset.

1. Priority of a security right in a negotiable instrument

155. Many States have adopted special priority rules for security rights in negotiable instruments, such as cheques, bills of exchange and promissory notes. These rules are a reflection of the importance of the concept of negotiability in those States.

156. As discussed (see chapter V on the effectiveness of a security right against third parties), in many States, security rights in negotiable instruments may be made effective either by registration of the security right in the general security rights registry or by transfer of possession of the instrument (see recommendation 37). In these States, priority is often accorded to a security right made effective against third parties by transfer of possession of the instrument over a security right made effective against third parties by registration, regardless of when registration occurs. The rationale for this rule is that it resolves the priority conflict in favour of preserving the unfettered negotiability of negotiable instruments. To preserve the coherence of existing law governing negotiable instruments (for a rule of interpretation with respect to the expression “law governing negotiable instruments”, see Introduction, section B, Terminology), the Guide recommends adopting this priority principle (see recommendation 98).

157. For the same reason, in these States, priority is often accorded to a buyer or other transferee (in a consensual transaction), if that person qualifies as a protected holder of the instrument under the law governing negotiable instruments. A like priority is also given if the buyer or other transferee takes possession of the instrument and gives value in good faith and without knowledge that the transfer is in violation of the secured creditor’s rights. It should be noted in this regard that knowledge of the existence of a security right on the part of a transferee of an instrument or a document does not mean, by itself, that the transferee did not act in good faith. The buyer must know that the transfer free of the security right is prohibited under the security agreement. Here also, the Guide adopts a priority rule that follows the above principles of negotiable instruments law (see recommendation 99).

2. Priority of a security right in a right to payment of funds credited to a bank account

158. A comprehensive priority regime typically addresses a number of different priority conflicts relating to security rights in rights to payment of funds credited to a bank account (for a definition of “bank account”, see Introduction, section B, Terminology). Some States consider the right to payment of funds credited to a bank account simply to be a receivable. In these States, no special rules govern the creation or the third-party effectiveness of security rights in the right to payment. In other States, third-party effectiveness may also be achieved by control. In these cases, States must also determine the priority consequences of achieving third-party effectiveness by such a method (see paras. 39 and 40 above). Several different priority conflicts are possible.

159. One type of priority conflict is between a security right made effective against third parties by control and a security right made effective against third parties by a method other than control. In this situation, States that have adopted the concept of control accord priority to the security right made effective against third parties by control. The reason is that that outcome facilitates financial transactions that rely on rights to payment of funds credited to a bank account, relieving secured creditors from the necessity of searching the general security rights registry. This is also the position taken in the Guide (see recommendation 100, first sentence).

160. A second type of priority conflict is that between two security rights, each of which is made effective by control. Here, the logical outcome, usually adopted in States that recognize control agreements, is to accord priority to the security right that was first made effective by control (i.e. in the order in which the respective control agreements were concluded). This conflict will not arise often in practice, because it is unlikely that a depositary bank will knowingly enter into more than one control agreement with respect to the same bank account in the absence of an agreement between both secured creditors as to how priority will be determined. Nonetheless, the conflict is theoretically possible, and the Guide therefore takes the position that the normal “first-in-time” priority principle should apply in these cases (see recommendation 100, second sentence).

161. Yet another type of priority conflict is where one of the secured creditors is the depositary bank itself. In this situation, a strong argument exists in favour of according priority to the depositary bank. As the depositary bank generally will win in such a situation by reason of the right of set-off that it generally enjoys under non-secured transactions law (unless it has expressly waived its right), a priority rule that favours the bank in this circumstance allows the conflict to be resolved within the confines of the priority regime without resorting to other law. Adoption of such a principle is recommended in the Guide (see recommendation 100, third sentence).

162. States that adopt the special priority rule just noted often make an exception for the circumstance in which the priority conflict is between the depositary bank and a secured creditor that obtains control of the bank account by becoming the customer of the depositary bank. In such cases, they generally take the position that priority should be given to the customer. The rationale for this approach is that, by accepting the competing secured creditor as its customer, the depositary bank generally releases its claim in the deposit agreement that it enters into with its

customer. Also, the depository bank would often lose its right of set-off in this situation; since the bank account is not in the grantor's name, there would be no mutuality between the depository bank and the grantor and hence, no right of set-off (see recommendation 100, third sentence).

163. A fourth type of conflict is one between a security right in a right to payment of funds credited to a bank account and any rights of set-off the depository bank might have against the grantor-client. To avoid undermining the bank-client relationship, the law of set-off generally gives priority to the depository bank's rights of set-off. In some States, this concept of priority has been explicitly incorporated into the secured transactions law. This is also the position that is recommended in the Guide (see recommendation 101).

164. A fifth type of priority conflict can arise between a security right in a right to payment of funds credited to a bank account and the rights of a transferee of funds from that bank account, where the transfer is initiated by the grantor. The term "transfer of funds" is intended to cover a variety of transfers, including by cheque and electronic means. In these situations, a strong policy argument in favour of the free negotiability of funds supports a rule that accords priority to the transferee, so long as the transferee was not aware that the transfer of funds to it was in violation of the rights of a secured creditor under its security agreement. If, on the other hand, the transferee knew that the transfer violated the security agreement, it would take the funds subject to the security right. This is the recommendation adopted in the Guide, subject to the caveat that the recommendation is not intended adversely to affect the rights of transferees of funds from bank accounts under law other than the secured transactions law (see recommendation 102).

3. Priority of a security right in money

165. In the interest of maximizing the negotiability of money, many States permit a transferee of money to take the money free of the claims of other persons, including the holders of security rights in the money (for the definition of "money", see Introduction, section B, Terminology). As in the case of transferees of funds from a bank account, the only exception to this priority rule is if the transferee has knowledge that the transfer of the money is in violation of the security agreement between the account holder and the secured party (e.g. if the transferee has colluded with the holder of the bank account to deprive the secured creditor of its rights). As in similar situations involving the transfer of funds from bank accounts, mere knowledge of the existence of the security right would not defeat the rights of the transferee. Here also, in keeping with generally accepted practice governing money, the Guide recommends adoption of this priority principle (see recommendation 103).

4. Priority of a security right in a right to receive the proceeds under an independent undertaking

166. The law governing independent undertakings has developed largely through practices in the letter-of-credit and bank-guarantee industry. As already mentioned (see chapter V on the effectiveness of a security right against third parties), a security right in a right to receive the proceeds under an independent undertaking is made effective against third parties only by control. As the typical method of achieving control in this context is by obtaining an acknowledgment, in the case of

several potential payers (e.g. the guarantor/issuer, confirmer and several nominated persons), control may be achieved only as against each particular guarantor/issuer, confirmer or nominated person that gave an acknowledgment. Thus, the priority rule normally focuses on the particular person that is the payer.

167. Normally, in the rare case of a priority contest between the holder of a security right in a right to receive the proceeds under an independent undertaking that has been made effective by control and a security right made effective against third parties by reason of the fact that it secures payment of a receivable, negotiable instrument or other intangible asset, the former will prevail (see recommendations 48 and 104). As in the case of bank accounts, this rule is based on the need to facilitate transactions involving independent undertakings by relieving parties of the necessity of searching the general security rights registry to determine whether the receivable supported by the independent undertaking is also subject to a security right, thereby encouraging reliance on independent undertakings. As a practical matter, this particular type of priority conflict is quite rare, because in most cases the beneficiary of the receivable will also be the beneficiary of the independent undertaking. In any case, consistent with the general “first-in-time” principle, as between two security rights made effective against third parties by control through acknowledgement, priority is accorded to the first security right to be acknowledged by the payer. The rationale for this result is largely practice-based, in that it is a special rule required in order to keep low the cost of independent undertakings. As independent undertakings constitute a highly specialized branch of commercial law that has been largely developed by practice, the Guide recommends that relevant priority rules be consistent with these principles (see recommendation 104).

5. Priority of a security right in a negotiable document or tangible assets covered by a negotiable document

168. Modern secured transactions regimes typically have rules that address at least two priority conflicts involving negotiable documents, such as negotiable warehouse receipts and bills of lading. The first is a conflict between the holder of a security right in a negotiable document or the tangible assets covered thereby, on the one hand, and a person to whom the document has been duly negotiated, on the other. In the interest of preserving negotiability under non-secured transactions law, most States provide that the security right in the negotiable document and the tangible assets covered thereby will be subordinate to any superior rights acquired by the transferee of the document under the law governing negotiable documents. For the same reason, this is the position recommended in the Guide (see recommendation 105).

169. The second type of conflict is between the holder of a security right in the tangible assets covered by the negotiable document that is derived from a security right in the negotiable document and the holder of a security right in the tangible assets resulting from some other transaction (e.g. the creation of a direct security right in the tangible assets). This type of conflict can arise either where the direct security right in the tangible assets became effective against third parties while the tangible assets were subject to the negotiable document or where the direct security right in the tangible assets became effective against third parties before the tangible assets became subject to the negotiable document. In either situation, priority is usually given to the security right in the negotiable document. Such a priority rule

encourages reliance on negotiable documents as a medium of commerce, especially in connection with bills of lading issued in connection with international sales. It is, therefore, the position taken in the Guide (see recommendation 106).

170. However, an exception to this rule is warranted in the particular situation where the tangible asset subject to the negotiable document is an asset other than inventory. Creditors normally expect that inventory will be shipped and a bill of lading or warehouse receipt issued, and therefore can anticipate a short period where assets that their security right directly encumbers will be covered by a bill or receipt. This is not usually the case with, for example, equipment. Hence, the rule giving absolute priority to security over negotiable documents has less significance, and an exception may be justified. Thus, the rule is inapplicable where the tangible assets are assets other than inventory and the direct security right (that is, the security right of the secured creditor not in possession of the negotiable document) was made effective against third parties before the earlier of: (a) the time the asset became covered by the negotiable document; and (b) the time when an agreement was made between the grantor of the security right and the secured creditor in possession of the negotiable document providing for the asset to be covered by the negotiable document, so long as the asset became so covered with a specified short period of time (such as 30 days) from the date of the agreement. In this particular case, the normal “first-in-time” priority rule would apply, and the first creditor to make its security in the tangible assets (whether directly or through taking security in a negotiable document representing those assets) effective against third parties will have priority. This exception provides a level of protection for holders of security rights in tangible assets other than inventory against situations in which the grantor, without notifying such holders and without their authorization, causes the assets to be covered by a negotiable document. For these reasons, the Guide also recommends that such an exception be adopted (see recommendation 106, second sentence).

C. Recommendations

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

A/CN.9/637/Add.2 [Original: English]

**Note by the Secretariat on terminology recommendations of the UNCITRAL draft
Legislative Guide on Secured Transactions, submitted to the Working Group on
Security Interests at its twelfth session**

ADDENDUM

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VIII. Rights and obligations of the parties

A. General remarks

1. Introduction

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

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

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

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

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

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

6. The discussion that follows focuses on three policy issues. The first, examined in section A.2, relates to the principle of party autonomy and the extent to which parties should be free to fashion the terms of their security agreement (assuming that the agreement satisfies the substantive and formal requirements for the creation of a security right). The second, explored in section A.3, relates to the mandatory rules that should govern pre-default rights and obligations of grantors and secured creditors. The third, which is the subject of sections A.4 and A.5, concerns the type of non-mandatory rules that could be included in modern secured transactions legislation.

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

2. Party autonomy

(a) General

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

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

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

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

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

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

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

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

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

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

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

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

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

(b) Source of rights and obligations of the parties

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

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

3. Mandatory pre-default rules

(a) General

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

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

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

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

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

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

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

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

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

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

(b) Duty to preserve the encumbered assets

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

4. Non-mandatory pre-default rules

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

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

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

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

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

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

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

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

5. Typical non-mandatory pre-default rules

(a) General

47. This chapter does not address all of the situations where States may wish to develop non-mandatory rules. For example, it does not deal with any non-mandatory

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

61. If the encumbered assets consist of income-producing assets in possession of the grantor, to the extent that the creditor's security right extends to the income or revenues generated by the asset, the grantor's duties may include maintaining adequate records and the reasonable rendering of accounts regarding the disposition and the handling of the proceeds derived from the encumbered assets. Specific obligations of the grantor in the case of intangible assets (e.g. rights to payment of funds credited to a bank account, royalties from the licensing of patents, copyrights and trademarks), and particularly the grantor's right to payment in the form of receivables, are discussed in the next section.

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

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

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

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

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

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

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

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

B. Asset-specific remarks

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

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

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

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

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

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

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

76. Because the right to payment is the actual object of the security, it is important to specify the effect of any payment made by the debtor of the receivable (whether to the assignor or the assignee) on the respective rights of assignor and assignee. Many States have enacted non-mandatory rules to govern payments made in good faith that may not actually be made according to the intention of the assignor or assignee. This can sometimes occur because the debtor of the receivable has

received conflicting payment instructions, or learns of the assignment without actually having received formal notice of it.

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

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

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

80. These mandatory and non-mandatory rules relating to pre-default rights and obligations of assignors and assignees of intangible assets help to structure the relationship between them. In many ways, the non-mandatory rules reflect what

suppletive rules are meant to accomplish, which is why they are explicitly stated in the national law of many States. For this reason also, the Guide recommends that they be included in any law relating to secured transactions so as to facilitate the efficient assignment and collection of receivables, while nonetheless permitting assignors and assignees to structure their own transactions differently so as to meet their own needs and wishes.

C. Recommendations

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

A/CN.9/637/Add.3 [Original: English]**Note by the Secretariat on terminology recommendations of the UNCITRAL draft
Legislative Guide on Secured Transactions, submitted to the Working Group on
Security Interests at its twelfth session****ADDENDUM****CONTENTS**

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IX. Rights and obligations of third-party obligors**A. General remarks****1. Introduction**

1. The standard example of a secured transaction is where a grantor encumbers a tangible asset, such as equipment or inventory, in favour of a secured creditor. In chapter III, however, the Guide also notes the importance of intangible assets in

modern secured transactions. While certain categories of intangible assets may be excluded from the Guide, many other types of intangible asset and, in particular, rights to payment are included (see recommendation 2, subparagraph (a)).

2. When the encumbered asset in a secured transaction consists of a right against a third party, the secured transaction is necessarily more complicated than when the encumbered asset is a simple object such as equipment. Such rights against third parties may include “receivables”, “negotiable instruments”, “negotiable documents”, “rights to receive the proceeds under an independent undertaking” and “rights to payment of funds credited to a bank account” (for the definitions of these terms, see Introduction, section B, Terminology). While these rights against third parties differ from each other in important ways, they have a critical feature in common: the value of the encumbered asset is the right to receive performance from a third-party obligor (that is, a third party who owes an obligation to the grantor). There could be rights against third parties that do not fall into one of these five categories for which the Guide does not provide specific recommendations. The Guide covers these rights as well when they serve as encumbered assets, and the same principles discussed in this chapter for the five specified categories apply to these other rights, except to the extent that their nature requires a different rule that might be found in another body of law that specifically addresses such rights. The remainder of this chapter will focus on the five categories of rights referred to above.

3. Depending on the nature of the right against a third party that is an encumbered asset, the Guide uses varying terminology to describe the third-party obligor. When the right is a receivable, for example, the third-party obligor is referred to as the “debtor of the receivable”, and when the obligation is the right to proceeds under an independent undertaking, the third-party obligor is referred to as the “guarantor/issuer, confirmer or other nominated person” (for the definitions of these terms, see Introduction, section B, Terminology).

4. When the encumbered asset is a right against a third-party obligor, the secured transaction affects not only the grantor and the secured creditor but may also affect the third-party obligor. Accordingly, States typically provide appropriate protection against adverse effects on the third-party obligor, especially since that obligor is not a party to the secured transaction. On the other hand, those protections should not unduly burden the creation of security rights in rights against third-party obligors, since security rights facilitate the extension of credit by the secured creditor to the grantor, which may also redound to the benefit of the third-party obligor.

5. The detailed rules governing the mutual rights and obligations of grantors and secured parties where the encumbered asset is a right to payment have been discussed in chapter VIII. This chapter first reviews, in section A.2 (a), a number of general issues. It then addresses, in sections A.2(b)-A.2(f), the rights and obligations of third-party obligors in the different contexts where they most frequently arise. The chapter concludes, in section B, with a series of recommendations.

2. Effect of a security right on the obligations of a third-party obligor

(a) General

6. It is generally recognized by States that it would be inappropriate for a security right in a right to performance from a third-party obligor to change the nature or magnitude of the third-party obligor’s obligation towards its creditor. This basic principle is also present in international instruments. For example, article 15 of the United Nations Assignment Convention permits no change in the obligation,

other than the identity of the person to whom payment is owed (and, with some limitations, the address or account to which payment is to be made; see para. 11 below). The principle is general, and equally applies to third-party obligors regardless of how the obligation arises or the manner in which it is expressed (e.g. whether the obligation is a right to payment under a negotiable instrument, a right to payment of funds credited to a bank account, a right to receive the proceeds under an independent undertaking, or a right under a negotiable document).

7. When a negotiable instrument or negotiable document evidences the right against the third-party obligor, this principle is already reflected in law that is well developed in most States and that details the effect of an assignment on the obligation of the obligor. This body of law is generally referred to in the Guide as negotiable instruments law. There is no need for secured transactions law to recreate those rules. Accordingly, the Guide generally defers to those bodies of law for effectuation of this principle. Similar protections exist under the law governing bank accounts and the law and practice governing independent undertakings, and the Guide defers to them as well.

(b) Effect of a security right on the obligations of the debtor of a receivable

8. While the effect of a security right on the obligor of a negotiable instrument or negotiable document is well developed in most States, this is not always the case with respect to a receivable that is the subject of a security right. Accordingly, the Guide addresses in some detail the effect of a security right on the obligation of the debtor of the receivable. For the most part, the Guide draws its policies and recommendations (often verbatim) from the analogous rules in the United Nations Assignment Convention.

9. In many States today, it is not possible to grant a security right in a receivable. The only mechanism by which the debtor of a receivable may use the claim as an asset to secure a loan is to transfer (or assign) the claim to a creditor. Moreover, in some States, it is not possible to assign a claim by way of security (that is, to make the assignee's right to collect the receivable contingent upon the assignor itself continuing to owe an obligation to the assignee). In these States, only outright (or pure) transfers of receivables are possible. Regardless of the type of the transaction (i.e. whether it is an outright assignment, a security arrangement denominated as a security right or a transfer by way of security), the legal mechanisms by which the mutual rights and obligations of the parties, and their rights as against third-party obligors are created are similar. For this reason, and because it is sometimes difficult to determine exactly the nature of the underlying transaction between the assignor and the assignee, many States treat all forms of transfer of receivables broadly in the same manner.

10. This is also the approach taken by the United Nations Assignment Convention, and consistent with that approach, the Guide covers not only security rights in receivables but also outright transfers and transfers by way of security (see recommendation 3; for the definition of the terms "assignment", "assignor" and "assignee" and related terms, see Introduction, section B, Terminology). Therefore, the discussion below covers the debtor of the receivable in transactions in which the receivable has been transferred outright or utilized as an encumbered asset (whether in an outright assignment for security purposes or an assignment by way of security), and the term "assignment" is used in this chapter to refer to all three types of transaction, except where otherwise indicated. However, this does not result in

converting an outright transfer of a receivable to a secured transaction (see recommendation 3).

11. The United Nations Assignment Convention provides that, with few exceptions, the assignment of a receivable does not affect the rights and obligations of the debtor of the receivable without its consent. A like principle is found in the national law of many States. The only effect that the assignment may have on the debtor of the receivable is to change the person, address or deposit account to which the debtor of the receivable is to make payment. However, so as not to impose hardship on the debtor of the receivable, the United Nations Assignment Convention provides that such changes of the person, address or account of payment may not result in changing the currency of payment or the State in which payment is to be made, unless the change is to the currency of the State in which the debtor of the receivable is located (see United Nations Assignment Convention, article 15, and recommendation 114).

12. When the assignment of a receivable is an outright transfer, the ownership of the right to receive performance from the debtor of the receivable also changes. While some States characterize this type of transaction as involving a change of ownership, others simply provide that the claim reflected by the receivable has been transferred to the patrimony of the assignee. However the transaction is characterized, it does not necessarily mean that the party to whom payment is to be made will also change. This is because, in many cases, the assignee will enter into a servicing or similar arrangement with the assignor pursuant to which the latter continues to collect the receivable on behalf of the assignee.

13. Even when the assignment of a receivable is by way of security, the transaction is sometimes structured as an immediate transfer to the assignee. In these cases, the assignor normally also collects the receivable on behalf of the assignee but, until default, need not remit more than is necessary under the agreement between them. Sometimes, by contrast, the assignment is conditional, and the assignee acquires no rights in the receivable until the occurrence of a default by the assignor. Until this moment, the third-party obligor will continue to pay the assignor under the terms of the original obligation contracted between them.

14. There is typically a like result when the assignment of a receivable involves the creation of a security right. The assignment does not necessarily mean that the party to whom payment is to be made will change. In many cases, the arrangement between the assignor and the assignee will be that payments are to be made to the assignor (at least before any default by the assignor). Only upon default will the assignee generally seek to receive payment directly from the debtor of the receivable. In other cases, the parties will agree that payments are to be made to the assignee. Under these types of arrangement, the assignee normally holds the money received in a separate account and withdraws from that account only an amount necessary to fulfil the assignor's payment obligation. The balance is held for the assignor, and remitted once the credit has been fully paid.

15. In view of the fact that the obligation of the debtor of the receivable normally will be discharged only to the extent of payment to the party entitled to payment under the law (and may not be discharged if mistakenly made to a different party), it has an obvious interest in knowing the identity of the party to which payment is to be made (which is not necessarily the "owner" of the receivable). Thus, many States protect the debtor of the receivable by providing that the debtor of the receivable is discharged by paying in accordance with the original contract until such time as it

receives notification of the assignment and of any change in the person or address to which payment should be made. This principle provides important protection to the debtor of the receivable since it avoids the possibility that a payment will be found not to discharge the debtor of the receivable because the payment was made to a party that was no longer the creditor of the receivable, even though the debtor of the receivable was unaware of the change in the creditor of the receivable (see United Nations Assignment Convention, article 17, paragraph 1, and recommendation 115, subparagraph (a)).

16. Once the debtor of the receivable has been notified of the assignment and any new payment instructions, however, it is appropriate to require it to pay in accordance with the assignment and instructions (subject to the limitation described in para. 10 above that the instructions may not change the currency of payment or the State in which payment is to be made unless the change is to the State in which the debtor of the receivable is located). This principle is critical to the economic viability of secured transactions where the encumbered asset being relied upon by the secured creditor is a receivable. If the debtor of the receivable were to continue to be able to pay the assignor, this would deprive the assignee of the value of the assignment. The value of the receivable is reduced because every payment made by the debtor of the receivable reduces the outstanding balance of the receivable. Being able to obtain payment directly from the debtor of the receivable once instructions have been given is especially important when the assignor is in financial distress (see United Nations Assignment Convention, article 17, paragraph 2, and recommendation 115, subparagraph (b)).

17. As noted above, it would be inappropriate for an assignment of a receivable to change the nature or magnitude of the obligation of the debtor of the receivable. One implication of that principle is that the assignment should not, without the consent of the debtor of the receivable, deprive it of defences arising out of the original contract or rights of set-off arising prior to the receipt of notification of an assignment (see United Nations Assignment Convention, article 18, and recommendation 116).

18. This principle should not, however, prevent the debtor of the receivable from agreeing that it may not raise against an assignee defences or rights of set-off that it could otherwise raise against the assignor. The effect of such an agreement is to confer on the receivable the same sort of “negotiability” that enables negotiable instruments to be enforced by “holders in due course” or “protected purchasers” without regard to defences or rights of set-off (for the meaning of the term “protected holder”, see, for example, article 29 of the United Nations Convention on International Bills of Exchange and International Promissory Notes¹ (the “United Nations Bills and Notes Convention”). As the receivable could have been embodied in a negotiable promissory note or similar negotiable instrument with the agreement of the debtor of the receivable, there is no reason to prevent the debtor of the receivable from agreeing to the same result as would have been achieved by the use of a negotiable promissory note or similar negotiable instrument (see recommendation 117, subparagraph (a)). However, in most States, as in the United Nations Bills and Notes Convention, there are certain defences that can be raised even against a holder in due course or other protected purchaser (see, for example, paragraph 1 of article 30 of the United Nations Bills and Notes Convention). In principle, the same result should follow when the debtor of a receivable agrees not

¹ Ibid., Sales No. E.95.V.16.

to raise defences against the assignee of a receivable (see United Nations Assignment Convention, article 19, paragraph 2, and recommendation 117, subparagraph (b)).

19. When a receivable is created by contract, it is always possible that the debtor of the receivable and its original creditor might modify the terms of the obligation at a later time. If such a receivable is assigned, the effect of that modification on the rights of the assignee must be determined. If the modification occurs before the assignment, the right actually assigned to the assignee is the original receivable as so modified. Most States also take the position that a debtor of the receivable is not affected by an assignment of which it has no knowledge. So, for example, if the modification occurs after the assignment, but before the debtor of the receivable has become aware that the creditor has assigned the receivable, it is understandable that the debtor of the receivable would believe that the agreement of modification was entered into with the creditor of the receivable and, thus, would be effective. Accordingly, States generally provide that such a modification is effective as against the assignee (see, e.g., United Nations Assignment Convention, article 20, paragraph 1, and recommendation 118, subparagraph (a)).

20. If the agreement to modify the terms of the receivable is entered into after the assignment has already occurred and after the debtor has been notified of it, such a modification is usually not effective unless the assignee consents to it. The reason is that, at this point, the assignee's right in the receivable has already been established and such a modification would change the assignee's rights without its consent. Some States, however, provide limited exceptions to this rule. For example, if the right to be paid on the receivable has not yet been fully earned by performance by the original creditor of the receivable (the assignor), and the original contract provides for the possibility of its modification, the modification may be effective against the assignee. In certain cases, the original contract need not even expressly provide for modification. The usual example would be where the original contract governs a long-term relationship between the debtor and the creditor of the receivable, and the relationship is of the sort that is frequently the subject of modification. In this situation, the assignee might anticipate that reasonable modifications might be made in the ordinary course of business even after the assignment. As a result, some States provide that a modification to which a reasonable assignee would consent is effective against the assignee, even if made after the debtor of the receivable is aware of the assignment, so long as the receivable has not yet been fully earned by performance (see United Nations Assignment Convention, article 20, paragraph 2, and recommendation 118, subparagraph (b)).

21. As a general rule, the assignor's right to receive payment from the debtor of the receivable arises because the assignor has performed the obligation for which payment is to be made (e.g. the sale of a vehicle, the performance of a service). Sometimes the debtor of the receivable may make a down-payment, or may pay part of the price in advance of the asset being delivered or the service being rendered. This payment may well end up in the hands of the assignee (either because the assignor has remitted it to the assignee or because the assignee has given notice to the debtor of the receivable and has obtained payment directly). Normally, contract law provides that, if one party does not perform, the other party may have the contract annulled or seek damages for the breach. However, once the payment has passed into the hands of the assignee, many States provide that the only recourse of the debtor of the receivable is against the assignor, and sums received by the

assignee cannot be recovered. The policy behind this rule flows from the general law of obligations. Absent fraud, creditors of a party in default under a contract are not permitted to reclaim money that may have been paid in good faith to other creditors. Hence, if payment is made to the assignor, which then transfers the payment to the assignee, or if payment is made directly to the assignee, the assignee stands in the same position as any other creditor that has been paid by the assignor, and should not be required to disgorge the payment received to the debtor of the receivable simply because the assignor has not performed its correlative obligation. In essence, this means that the debtor of the receivable bears the insolvency risk of its contractual partner. The Guide recommends adoption of a rule reflecting this general principle (see recommendation 119).

(c) Effect of a security right on the obligations of the obligor on a negotiable instrument

22. In most States, the law governing negotiable instruments (for the meaning of this expression, see Introduction, section B, Terminology, para. 6) is well developed and contains clear rules as to the effect of a transfer of an instrument on the obligations of parties to the instrument. In principle, those rules continue to apply in the context of security rights in negotiable instruments (see recommendation 120).

23. Thus, for example, a secured creditor with a security right in a negotiable instrument is not able to collect on the instrument except in accordance with its terms. Even if the grantor has defaulted on its obligation under the security agreement, the secured creditor cannot enforce the negotiable instrument against an obligor except when payment is due under that instrument. For example, if a negotiable instrument is payable only at maturity, a secured creditor is not permitted to require payment prior to its maturity (even if the grantor of the security right, as opposed to the obligor on the instrument, is in default), except in accordance with the terms of the negotiable instrument itself.

24. In addition, unless otherwise agreed by the obligor, the secured creditor cannot collect on the negotiable instrument except in accordance with the law governing negotiable instruments. Typically, as a matter of the law governing negotiable instruments, the secured creditor may only collect on the negotiable instrument if it is a holder (that is, is in possession of the instrument and has obtained any necessary endorsement) or has acquired the rights of a holder. Accordingly, in order to be assured of obtaining a discharge, the obligor is often permitted to insist, under the law governing negotiable instruments, on paying only the holder of the instrument. However, in some States, a transferee of an instrument from a holder can enforce the instrument if the transferee has possession of the instrument.

25. Under the law governing negotiable instruments, the secured creditor may or may not be subject to the claims and defences of an obligor on the instrument. If the secured creditor is a “protected” holder of the negotiable instrument, the secured creditor is entitled to enforce the negotiable instrument free of certain claims and defences of the obligor. These claims and defences are the so-called “personal” claims and defences, such as normal contract claims and defences, which the obligor could have asserted against the prior holder. However, the secured creditor, even as a protected purchaser, remains subject to so-called “real” defences of the obligor, such as lack of legal capacity, fraud in the inducement or discharge in insolvency proceedings.

26. If the secured creditor is a holder of the negotiable instrument but not a “protected” holder, it is nonetheless entitled to collect on the negotiable instrument, but will usually be subject to the claims and defences that the obligor could have asserted against a prior holder of the negotiable instrument. These claims and defences include all “personal” claims and defences unless the party liable on the negotiable instrument has effectively waived its right to assert such claims and defences in the negotiable instrument itself or by separate agreement.

(d) Effect of a security right on the obligations of the depositary bank

27. In States in which a security right in a right to payment of funds credited to a bank account may be created only with the consent of the depositary bank, the bank has no duty to give its consent. In these States, the result is that, even as between the secured creditor and the grantor, a security right may not be created in a right to payment of funds credited to the bank account without the agreement of the bank. By contrast, other States do not require the consent of the depositary bank for the creation of the security right. Nonetheless, even in these States the rights and obligations of the depositary bank itself may not be affected without its consent (see recommendation 121, subparagraph (a)). In both cases, the main reason lies in the critical role of banks in the payment system and the need to avoid interfering with banking law and practice (see also para. 28).

28. The reason for not imposing duties on a depositary bank or changing the rights and duties of the depositary bank without its consent is that this may subject the bank to undue risks that it is not in a position to manage without having appropriate safeguards in place. The depositary bank is subject to significant operational risks, with funds being debited or credited to bank accounts on a daily basis, often with credits being made on a provisional basis, and sometimes involving other transactions with its customers. These risks are compounded by the legal risk to the depositary bank of failing to comply with laws dealing with negotiable instruments, credit transfers and other payment system rules in its day-to-day operations. The bank is also exposed to the further risk of not complying with certain duties imposed on the depositary bank by other law, such as laws requiring it to maintain the confidentiality of its dealings with its customers. In addition, the depositary bank is typically subject to regulatory risk under laws and regulations of the State designed to ensure the safety and soundness of the depositary bank. Finally, the depositary bank is subject to reputational risk in choosing the customers with which it agrees to enter into transactions.

29. The experience in those States where the depositary bank’s consent to new or changed duties is required suggests that the parties are often able to negotiate satisfactory arrangements so that the depositary bank is comfortable that it is managing the risks involved, given the nature of the transaction and the bank’s customer. In particular, to avoid any interference with the depositary bank’s rights of set-off against the account holder, legal systems that permit the depositary bank to obtain a security right in the right to payment of funds credited to a bank account held with the bank, provide that the bank retains any rights of set-off it might have under law other than the secured transactions law (see recommendation 121, subparagraph (b)).

30. The same principles apply with respect to the third-party effectiveness, priority and enforcement of a security right in a right to payment of funds credited to a bank account. For example, in States that prescribe “control” as the method for achieving third-party effectiveness of a security right in a right to payment of funds credited to

a bank account, there are appropriate rules to safeguard the confidentiality of the relationship of a bank and its client (for the definition of “control”, see Introduction, section B, Terminology). Such rules provide, for example, that the bank has no obligation to respond to requests for information about whether a control agreement exists or whether the account holder retains the right to dispose of funds credited to its bank account (see recommendation 122, subparagraph (b)).

31. In States in which the security right in a right to payment of funds credited to a bank account is made effective against third parties by registration of a notice in a public registry or by acknowledgment on the part of the depositary bank, the notice or acknowledgement may or may not impose duties on the depositary bank to follow instructions from the secured creditor as to the funds in the account. If such duties are not imposed on the depositary bank under the laws of a particular State, the secured creditor’s right to obtain the funds in the bank account upon enforcement of the security right would usually depend upon whether the customer-grantor has instructed the depositary bank to follow the secured creditor’s instructions as to the funds or the depositary bank has agreed with the secured creditor to do so. In the absence of such instructions or agreement, the secured creditor may need to enforce the security right in the bank account by using judicial process to obtain a court order requiring the depositary bank to turn over the funds credited to the bank account to the secured creditor.

32. In States in which the depositary bank is permitted to subordinate its priority position, the bank has no duty to subordinate its rights to a security right being asserted by another creditor of the account holder. Even if, in order to facilitate the creation, effectiveness against third parties, priority and enforcement of a security right in a right to payment of funds credited to a bank account, the secured creditor is willing to become the depositary bank’s customer with respect to the bank account, the depositary bank has no duty to accept the secured creditor as the bank’s customer. This result is consistent with the general position taken in the Guide that any mechanisms by which secured transactions law aims to facilitate the grant of security over funds credited to a bank account should not impair national regulatory laws or other laws designed to assure the safety and soundness of the banking system.

(e) Effect of a security right on the obligations of the guarantor/issuer, confirmer or nominated person under an independent undertaking

33. The rights and duties of the guarantor/issuer, confirmer or nominated person with respect to an independent undertaking are quite well developed under the law and practice governing independent undertakings (for the definitions of these terms, see Introduction, section B, Terminology). This highly specialized law and practice has facilitated the usefulness of independent undertakings, particularly in international trade. Accordingly, when developing a secured transactions law with respect to independent undertakings, great care should be taken to avoid interfering with these useful commercial mechanisms.

34. In order to avoid such interference, it is helpful to distinguish between the independent undertaking itself and the right to draw, on the one hand, and the right of a beneficiary of such an undertaking to receive a payment (or another item of value) due from the guarantor/issuer or nominated person, on the other hand. While providing for a security right in the former without interference with the usefulness of the independent undertaking is a delicate task (usually done by an agreed-upon transfer of the undertaking itself), a security right in the latter carries fewer risks

because it relates only to the right of the beneficiary to receive whatever may become due and would not have an effect on the guarantor/issuer, confirmer or a nominated person. For this reason, the Guide recommends rules facilitating the use as security of the right to receive the proceeds under an independent undertaking (a carefully defined term that refers to the right to receive the proceeds as contrasted with the cash and other assets that actually constitute the proceeds of the independent undertaking, as that term is commonly used in independent undertaking practice), but with strict conditions designed to avoid compromising the usefulness of independent undertakings. The basic rules that should govern the interaction of the law relating to independent undertakings and secured transactions law are described below.

35. A cardinal principle is that a secured creditor's rights in the right to receive the proceeds under an independent undertaking should be subject to the rights, under the law and practice governing independent undertakings, of the guarantor/issuer, confirmer or nominated person. Thus, a secured creditor may not assert a right to payment of the proceeds otherwise not payable to the secured creditor's grantor. For the same reason, a transferee-beneficiary normally takes the undertaking (including both the right to draw and the right to receive payment of the proceeds) without being affected by a security right in the proceeds of the independent undertaking granted by the transferor (see recommendation 123, subparagraphs (a) and (b)). For the same reason, if the guarantor/issuer, confirmer or nominated person has a security right in the proceeds under an independent undertaking, their independent rights are not adversely affected (see recommendation 123, subparagraph (c)).

36. Equally important is the principle that a guarantor/issuer, confirmer or nominated person should not be obligated to pay any person other than a confirmer, a nominated person, a named beneficiary, an acknowledged transferee of the independent undertaking or an acknowledged assignee of the proceeds under an independent undertaking (see recommendation 124). The reason for this rule is that the usefulness of independent undertakings as a low-cost and efficient method for facilitating the flow of commerce would be compromised if the guarantor/issuer, confirmer or nominated person had to verify the background transaction by which the right was purportedly transferred and to which it had not consented. If, however, the guarantor/issuer, confirmer or nominated person acknowledges a secured creditor or transferee of the proceeds under an independent undertaking, the secured creditor or transferee may enforce its rights against the person that made the acknowledgement (see recommendation 125).

(f) Effect of a security right on the obligations of the issuer or other obligor under a negotiable document

37. In most States, the law governing negotiable documents is well developed and contains clear rules as to the effect of a transfer of a document on the obligations of parties to the document. In principle, those rules continue to apply in the context of security rights in negotiable documents (see recommendation 126).

38. This means, among other things, that the right of a secured creditor to enforce a security right in a negotiable document and, thus, in the tangible assets covered by it, is limited by the law governing negotiable documents. The limit is that the assets covered by the negotiable document are in the hands of the issuer or other obligor under that document, and the issuer's or other obligor's obligation to deliver the assets typically runs only to the consignee or to any subsequent holder. Thus, if the negotiable document was not transferred to the secured creditor in accordance with

the law governing negotiable documents, the issuer or other obligor will have no obligation to deliver the assets to the secured creditor. For example, if under negotiable documents law, the document must bear an endorsement at the time it is transferred in order for the transferee to be entitled to receive the assets covered by the document, and the transferee holds a document without such an endorsement, the obligor need not deliver the assets covered by the document. In such a case, the secured creditor may need to obtain an order from a court or other tribunal in order to obtain possession. The court order would either require transfer of the document (or its transfer and endorsement) to the secured creditor or to a person designated by the secured creditor, or require the issuer or other obligor to deliver the assets to the secured creditor or other person designated by the secured creditor.

B. Recommendations

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

A/CN.9/637/Add.4 [Original: English]

**Note by the Secretariat on terminology recommendations of the UNCITRAL draft
Legislative Guide on Secured Transactions, submitted to the Working Group on
Security Interests at its twelfth session**

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X. Enforcement of a security right

A. General remarks

1. Introduction

1. Parties to any agreement usually expect each other voluntarily to perform all their obligations, whether owed between themselves or to third parties and whether these obligations arise by contract or by operation of law. Only where performance is not forthcoming do parties contemplate compulsory enforcement through a judicial procedure. Typically, States carefully develop enforcement regimes for

ordinary civil actions that balance the rights of debtors, creditors and third parties. In most States, these regimes require a creditor seeking to enforce performance to bring a court action to have the claim recognized and then to have the debtor's assets seized and sold under the supervision of a public official. From the amount generated by the sale, the judgement creditor will receive payment of its outstanding claim against the judgement debtor.

2. Parties to a security agreement have similar expectations of each other. A secured creditor usually presumes that a grantor will perform its obligations voluntarily. Likewise, a grantor will typically expect the secured creditor to fulfil the obligations it has undertaken. Both enter the transaction fully expecting and intending to meet their obligations to each other. Yet both also recognize that there will be times when they may not be able to do so. Sometimes the secured creditor will fail to make a promised payment, or to return assets to a grantor when an agreed condition for doing so occurs. In such cases, depending on the nature of the agreement between them, the grantor will normally apply to the court for relief. Most often, however, it is the grantor that finds itself incapable of performing as promised (that is, will not repay the credit according to the terms of the agreement). The failure will sometimes flow from reasons beyond the grantor's control, such as an economic downturn in an industry or more general economic conditions. Sometimes it may result from defaults by the grantor's own debtors. Sometimes the grantor cannot perform owing to business misjudgements, or as a consequence of poor management.

3. Whatever the reason, even after one or more payments have been missed, it is in the interest of both parties to a security agreement, and of third parties generally, that the grantor attempt to make up these payments and continue voluntarily to perform the promised obligation. Compulsory enforcement proceedings are always less efficient than voluntary performance, since: (a) they are costly; (b) they take time; (c) the outcome is not always certain; (d) they usually lead to a complete breakdown in the relationship between the parties; and (e) the longer-term consequences for grantors and third parties are often devastating. This is why many States actively encourage parties to a security agreement to take steps to avoid a failure of performance that would lead to compulsory enforcement. Moreover, this is why secured creditors often will closely monitor their grantors' business activities. For example, they will periodically review account books, inspect the encumbered assets and communicate with those grantors that show signs of financial difficulty. Grantors having trouble meeting their obligations generally will cooperate with their secured creditors to work out ways to forestall or to overcome their difficulties. In some cases, a grantor may request a secured creditor's assistance in developing a new business plan. In other cases, the grantor and an individual creditor, or the grantor and its whole group of creditors working together, may attempt informally to readjust aspects of their agreements.

4. There are many types of debt-readjustment agreements. Sometimes the parties enter into a "composition" or "work-out" arrangement that extends the time for payment, otherwise modifies the grantor's obligation, or adds or reduces encumbered assets that secure these obligations. Negotiations to reach a composition agreement take place against a background of two main factors: (a) the secured creditor's right to enforce its security rights in the encumbered assets if the grantor defaults on its secured obligation; and (b) the possibility that insolvency proceedings will be initiated by or against the grantor.

5. Nevertheless, despite the best efforts of grantors and secured creditors to avoid compulsory enforcement proceedings, they will occasionally be unavoidable. One of the key issues for States enacting secured transactions regimes is, consequently, to decide the scope of a creditor's post-default rights. More specifically, the question is what modifications, if any, States should make to the normal rules that apply to the enforcement of claims when developing rules to govern how security rights can be enforced when the grantor fails to perform the secured obligation.

6. At the heart of a secured transactions regime is the right of the secured creditor to look to the amount that can be realized upon the sale of the encumbered assets to satisfy the secured obligation. Enforcement mechanisms that allow creditors accurately to predict the time and cost involved in disposing of the encumbered assets and the likely proceeds received from the enforcement process will have a significant impact on the availability and the cost of credit. A secured transactions regime should, therefore, provide efficient, economical and predictable procedural and substantive rules for the enforcement of a security right after a grantor has defaulted. At the same time, because enforcement will directly affect the rights of the grantor, other persons with a right in the encumbered assets and the grantor's other creditors, a secured transactions regime should provide reasonable safeguards to protect their rights.

7. All interested parties benefit from maximizing the amount achieved from the sale of the encumbered assets. The secured creditor benefits by the potential reduction of any amount that the grantor may owe as an unsecured obligation after application of the proceeds of enforcement to the outstanding secured obligation ("deficiency"). At the same time, the grantor and the grantor's other creditors benefit from a smaller deficiency or a larger amount remaining after satisfaction of the secured obligation ("surplus").

8. This chapter examines the secured creditor's right to enforce its security right if the grantor fails to perform ("defaults on") the secured obligation. If the grantor is insolvent, insolvency law may limit the exercise of these rights (see chapter XIV, on the impact of insolvency on a security right). In section A.2 of the present chapter, the general principles guiding default and enforcement are discussed. Section A.3 reviews the procedural steps that a secured creditor may be required to follow prior to exercising its remedies and sets out the grantor's post-default rights. The different remedies typically available to secured creditors are examined in section A.4. In section A.5, the effects of enforcement on the grantor, the secured creditor and third parties are considered. The enforcement of a security right in proceeds is discussed in section A.6. The intersection of the enforcement regimes relating to movable assets and immovable property is discussed in section A.7. Finally, the types of adjustment that may be necessary for effective enforcement against attachments to movable assets, masses and products are discussed in section A.8.

9. The enforcement of security rights in receivables, negotiable instruments, rights to payment of funds credited to a bank account, rights to receive the proceeds under an independent undertaking and negotiable documents does not fit easily into the general procedures for enforcement against tangible assets (for the definitions of those terms, see Introduction, section B, Terminology). As a result, many States have particular rules dealing with enforcement against intangible assets, receivables and various other rights to payment. These special situations are discussed in sections B.1-B.7 of this chapter. The chapter concludes, in section C, with a series of recommendations.

2. General principles of enforcement

(a) General

10. As noted in the preceding section, it is in everyone's interest that the grantor voluntarily performs its promised obligation. For this reason, when performance is not forthcoming, the secured creditor and the grantor normally will attempt to conclude an agreement that obviates the need to commence compulsory enforcement proceedings. Seldom will a grantor be unaware that it is not performing its obligations and even more rarely, if ever, will the grantor learn for the first time that it is in default by means of a formal indication to this effect from the secured creditor. Indeed, in the latter case, enforcement proceedings usually do not follow since the failure of performance will almost always have been due to inadvertence rather than an inability or unwillingness to pay. Still, compulsory enforcement will sometimes become necessary. When it does, a number of basic principles guide States in elaborating the post-default rights and obligations of secured creditors and grantors.

(b) Requirement of a default prior to enforcement

11. A security right secures the performance of a grantor's (or, in the case of a third-party grantor, the debtor's) obligation to the secured creditor. In the standard case, therefore, the security right becomes enforceable as soon as the grantor fails to pay the secured obligation. There are, however, a number of other "events of default" that are typically set out in the security agreement. Any one of these events, unless waived by the secured creditor, is sufficient to constitute a default, thereby permitting compulsory enforcement of the security right. In other words, the parties' agreement and the general law of obligations will determine whether the grantor is in default and when enforcement proceedings may be commenced. This general law of obligations usually will also determine whether a formal notice of default must be given to the debtor and, if so, what the content of that notice will be.

12. Occasionally, default occurs not because a payment has been missed, but because another creditor either seizes the encumbered assets under a judgement or seeks to enforce its own security right. Some States provide that, apart from any stipulation in the security agreement, the seizure of encumbered assets by any other creditor constitutes a default under all security agreements that encumber the seized assets. The rationale is based on efficiency. As the encumbered asset is the creditor's guarantee of payment, whenever that asset is subject to judicial process, the secured creditor should be able to intervene to protect its rights. In these cases, procedural law will often give these other creditors the right to force the disposition of encumbered assets. The secured creditor will look to this same procedural law for rules on intervening in these judicial actions and enforcement proceedings in order to protect its rights and its priority.

13. Typically, States provide that a secured creditor with priority will be able to take over the enforcement process from a subordinate secured creditor should it so choose. This rule follows because the two secured creditors will be enforcing similar rights under the same security regime and the enforcement rights of these creditors should, therefore, be determined by their respective priority. Other States protect the rights of creditors with a higher priority ranking ("senior creditors") by providing that any realization sale by a creditor with a lower priority ranking (a "junior creditor") cannot affect the rights of a senior creditor.

14. In some States, once enforcement of a judgement claim has commenced, the secured creditor may not intervene to enforce its rights under the security agreement. This approach is usually followed in States where a judicial sale extinguishes all rights, including security rights, from the assets sold. The assumption is that because the judicial sale enables the purchaser to acquire a clean title, it will produce the highest enforcement value. In other States, however, where a secured creditor has rights in some or all of the assets under seizure by a judgement creditor, the secured creditor is permitted to counter the seizure and enforce its security rights by any means available to it. This approach is usually found in States where a regular judicial sale in execution does not extinguish security rights. The assumption is that since security rights will not be extinguished, a higher price of disposition is more likely to be realized when the enforcement process leads to the purchaser obtaining the cleanest title (see paras. 70 and 72 below).

(c) Good faith and commercial reasonableness

15. Enforcement of a security right has serious consequences for grantors, debtors and interested third parties (e.g. a junior secured creditor, a guarantor or a co-owner of the encumbered assets). For this reason, some States impose, as a general and overriding obligation of secured creditors, a specific duty to act in good faith and follow commercially reasonable standards when enforcing their rights. Because of the importance of this obligation, these States also provide that at no time may the secured creditor and the grantor waive or vary it (see recommendations 128 and 129). Moreover, as noted, a secured creditor that does not comply with enforcement obligations imposed on it will be liable for any damages caused to the persons injured by its failure (see recommendation 133). For example, if a secured creditor does not act in a commercially reasonable manner in disposing of the encumbered assets and that results in the secured creditor obtaining a smaller amount than a commercially reasonable disposition would have produced, the secured creditor will owe damages to any person harmed by that differential.

(d) Freedom of parties to agree to the enforcement procedure

16. States generally impose very few pre-default obligations on parties to a security agreement (see chapter VIII, Rights and obligations of the parties to a security agreement). A key issue in the post-default enforcement context is, consequently, whether a similar policy should prevail. In other words, the issue is to what extent the secured creditor and the grantor should be permitted to modify either the statutory framework for enforcing security rights or their respective contractual rights as set out in the security agreement. Some States consider the enforcement procedure to be part of mandatory law that the parties cannot modify by agreement. In other States, the parties are allowed to modify the statutory framework for enforcement as long as public policy, priority, and third-party rights (in particular in the case of insolvency) are not affected. In yet other States, emphasis is placed on efficient enforcement mechanisms in which judicial enforcement is not the exclusive or the primary procedure. Hence, even if there are limits on the extent to which the secured creditor and the grantor may agree to modify the statutory framework in their security agreement (because the freedom to vary an enforcement obligation may be the subject of abuse at the time of conclusion of the security agreement), these States permit them to waive or modify their rights under the security agreement after a default occurs.

17. States that permit parties to waive their legal or contractual post-default rights by agreement nonetheless impose a number of restrictions on their capacity to do so. For example, they generally do not permit waiver of the creditor's obligation to act in good faith and in a reasonably commercial manner (see recommendation 129). As for other obligations, many States distinguish between the rights of the grantor and those of the secured creditor. In some States, the grantor may waive or agree to vary the secured creditor's post-default obligations only after a default has occurred. Allowing a waiver after default often enables the grantor and the secured creditor to "work out" in a non-adversarial way a disposition of the encumbered assets in a manner that maximizes the amount that can be realized for the benefit of the secured creditor, the grantor and the other creditors of the grantor (see recommendation 130). These same States usually also permit a secured creditor to waive its rights against the grantor at any time (either prior to or after default) on the assumption that there is little risk that abusive terms would be imposed by the grantor at the time the credit is being extended (see recommendation 131). In any case, a variation of rights by the parties to a security agreement does not affect the rights of third parties and any person challenging the agreement has the burden of proof (see recommendation 132).

(e) Judicial supervision of enforcement

18. Generally speaking, when a grantor is in default and attempts to work out the obligations have failed, compulsory enforcement against the encumbered assets is likely to ensue. In some cases, however, grantors will contest either the secured creditor's claim that they are in default, or the secured creditor's calculation of the amount owed as a result of the default. As a matter of public policy, States generally provide that grantors are always entitled to request courts to confirm, reject, modify or otherwise control the exercise of a creditor's enforcement rights.

19. The point is not to burden secured creditors with unnecessary judicial procedures, but rather to enable grantors and other interested parties to ensure respect for mandatory post-default procedures (see recommendation 134). Consequently, to ensure that grantor challenges to enforcement can be dealt with in a time- and cost-efficient manner, many States replace the normal rules of civil procedure with expedited judicial proceedings in these cases (see recommendation 135). For example, grantors and other interested parties may be given only a limited time within which to make a claim or raise a defence. Other States permit grantors to challenge the secured creditor on these issues even after enforcement has commenced, or at the time proceeds of enforcement are distributed, or when the secured creditor seeks to collect any deficiency. Still other States permit grantors to obtain not only compensatory damages, but also punitive damages, should it be shown that the secured creditor either had no right to enforce, or enforced for an amount greater than that actually owed.

20. Furthermore, because all such challenges will delay enforcement and add to its cost, many States also build safeguards into the process to discourage grantors from making unfounded claims. These include procedural mechanisms, such as adding the costs of the proceedings to the secured obligation in the event that they are unsuccessful, or requiring affidavits from grantors as a prerequisite to launching such proceedings. Some States also permit secured creditors to seek damages against grantors that bring frivolous proceedings, or fail to comply with their obligations, and to add these damages to the secured obligation. The Guide recommends that compensatory damages be available if the grantor fails to comply

with any of its post-default obligations (see recommendation 133; the same rule applies to the secured creditor).

(f) Scope of post-default rights of the grantor

(i) General

21. As mentioned above, the grantor may seek court relief if the secured creditor fails to exercise its post-default rights in accordance with the security agreement and the law (see paras. 18-20). The grantor may also pay the secured obligation in full and obtain a release of the encumbered assets (see paras. 22-26 below). In addition, the grantor may propose to the secured creditor to take the encumbered assets in total or partial satisfaction of the secured obligation (or object to such a proposal of the secured creditor; see paras. 60-64), as well as exercise any other remedy provided for in the security agreement or the law (see recommendation 136). The grantor may also object to the extrajudicial taking of possession by the secured creditor or to the extrajudicial disposition of the encumbered assets (see recommendations 139, 144 and 145; see also paras. 29-32 and 48-56 below).

(ii) Extinction of the security right after full payment of the secured obligation

22. Once a default has been signalled, the debtor, third-party grantor and interested third parties will often attempt to refinance the secured obligation or otherwise remedy the alleged default. In such cases, States must decide what rights these different parties may exercise and within what time frame they may be exercised. Typically grantors and third parties are given the right to obtain a release of the encumbered assets from the security right upon full repayment of the secured obligation.

23. Full payment of the secured obligation (and termination of any credit commitment) extinguishes the security right and brings the secured transaction to an end. As the objective of enforcement proceedings is to enable creditors to obtain repayment of the obligation, States are usually quite flexible about which parties are entitled to pay the secured obligation. For example, most States permit a defaulting grantor to seek to obtain a release of the encumbered assets before their final disposition by the secured creditor upon paying the outstanding amount of the secured obligation, including interest and the costs of enforcement incurred up to the time of repayment. States usually also permit any interested third party (e.g. a creditor with a lower priority ranking than that of the enforcing creditor or a purchaser that takes the assets subject to the security right) to exercise the right of repayment if the grantor does not.

24. In addition, States usually take a flexible position in relation to the time within which repayment may be made. The secured creditor's interest is in being paid. As long as this payment of principal, interest and costs incurred for enforcement occurs before any third-party rights are affected, there is no reason for insisting on disposition of the encumbered asset. This means that, whoever exercises the right may do so up until the time of: (a) disposition of the encumbered asset or the completion of collection by the secured creditor after disposition of the encumbered asset; (b) the secured creditor entering into a commitment to dispose of the encumbered asset; or (c) acquisition by the secured creditor of the encumbered asset in total or partial satisfaction of the secured obligation, whichever occurs first. Until one of these events occurs, the secured obligation may be repaid in full and the

encumbered assets released. For the same reasons (recognizing that the creditor's primary interest is in receiving payment and the grantor's primary interest is in not losing its assets), the Guide recommends that repayment leading to release of the encumbered assets be permitted right up until third-party rights are acquired, an agreement for the disposition of the assets has been concluded or the secured creditor has acquired the encumbered asset in satisfaction of the secured obligation (see recommendation 137).

25. Another post-default right given to grantors in some States is the reinstatement of the secured obligation upon payment of any arrears. Reinstatement of the secured obligation is quite different from the extinction of the security right and is usually more narrowly circumscribed. Reinstating the secured obligation means curing the specific default (e.g. paying any missed instalments, accrued interest and costs of enforcement already incurred), but otherwise it has no effect either on the grantor's continuing duty to perform or on the security right. The reinstated obligation remains enforceable according to the terms agreed by the parties and remains secured by the encumbered assets.

26. States take quite different approaches to the reinstatement right. Some do not legislatively provide for a reinstatement right, but allow parties to provide for such a right in the security agreement. By contrast, some States provide that reinstatement is a right that may not be waived and may only be exercised by the grantor. Finally, some States permit any interested party to cure a default and reinstate the secured obligation. Whenever reinstatement is permitted, parties authorized to do so may exercise the right up to the same time that parties authorized to release the encumbered assets may exercise their right of release. As reinstatement maintains rather than extinguishes the secured obligation, the grantor may later again fall into default. To prevent a series of strategic defaults and reinstatements, States that permit reinstatement usually limit the number of times that a secured obligation may be reinstated after default. The Guide does not contain a specific recommendation concerning reinstatement. The main reason for this approach is that the decision whether or not to permit acceleration clauses in security agreements (which would make the reinstatement right moot) is considered to be more properly a matter to be addressed by a State's general law of obligations.

(g) Scope of post-default rights of the secured creditor

27. A general creditor that obtains a judgement may enforce the judgement against all the debtor's assets that procedural law allows to be seized. This generally will include all the debtor's assets of whatever kind. If the debtor has only a limited right in assets, only that limited right (e.g. a usufruct) may be seized and sold. Similarly, if a debtor's rights in assets are limited by a term or a condition, the enforcement against the asset will be likewise limited. The purchaser at the judicial sale may only acquire the asset subject to the same term or condition.

28. Unlike the case of ordinary enforcement of judgements, the enforcement of security rights is subjected to an important additional limitation. A secured creditor may only proceed against the assets actually encumbered by its security right and not as against the grantor's entire estate (the secured creditor may exercise any remedies available to an unsecured creditor to claim a deficiency against the grantor). Within this additional constraint, principles similar to those governing enforcement in general apply to the enforcement of a security right. The secured creditor may only enforce the security right against the particular proprietary rights that the grantor actually has in the encumbered assets. So, for example, if a

grantor's ability to sell or otherwise dispose of, lease or license an encumbered asset is limited, the secured creditor's enforcement may not override those restrictions. This means that, for example, if a grantor holds assets as a licensee of a trademark licence, the security right would encompass only the grantor's right as a licensee subject to enforceable terms in the trademark licence and would not give the secured creditor any general right to use or dispose of the trademark.

(h) Judicial and extrajudicial enforcement

29. As a general principle of debtor-creditor law, most States require claims to be enforced by judicial procedures. Creditors must sue their debtors, obtain judgement and then resort to other public officials or authorities (e.g. bailiffs, notaries or the police) to enforce the judgement. In order to protect the grantor and other parties with rights in the encumbered assets, some States impose a similar obligation on secured creditors, requiring them to resort exclusively to the courts or other governmental authorities to enforce their security rights. However, as court proceedings can be slow and costly, often they are less likely to produce the highest possible amount upon the disposition of the assets being sold. In addition, because the expenses involved in enforcement will be factored into the cost of the financing transaction, inefficient processes will have a negative impact on the availability and the cost of credit.

30. To facilitate secured transactions, some States require only a minimal prior intervention by public officials or authorities in the enforcement process. For example, the secured creditor may be required to apply to a court for an order of repossession, which the court will issue without a hearing. In other cases, once the secured creditor is in possession of the asset, it may sell it directly without court intervention as long as it hires a certified bailiff to manage the process according to prescribed procedures. The justification for a less formal approach lies in the fact that having the secured creditor or a trusted third party take control and dispose of the assets will often be more flexible, quicker and less costly than a State-controlled process. A properly designed system can provide protection to the grantor and other persons with an interest in maximizing the amount that will be achieved from the sale of the encumbered assets while at the same time providing an efficient system for realizing on the encumbered assets. Moreover, the knowledge that judicial intervention is readily available is often sufficient to create incentives for cooperative and reasonable behaviour that obviates the need to actually resort to the courts. Finally, unlike the typical judgement creditor, most secured creditors are in the business of providing credit. Hence, reputation concerns will normally impose constraints on their enforcement behaviour.

31. In some States, the secured creditor is not required to use the courts or other governmental authorities for any enforcement purposes, but is entitled to make exclusive use of extrajudicial procedures. These States usually impose, in these cases, a number of mandatory rules relating to, for example, the obligation to send a notice of default or notice of intended disposition, the obligation to act in good faith and in a commercially reasonable manner, and the obligation to account to the grantor for the proceeds of disposition. In addition, they do not permit the secured creditor to take possession of the encumbered assets extrajudicially if such enforcement would result in a disturbance of the public order. The purpose and effect of these requirements is to provide for flexibility in the methods used to dispose of the encumbered assets so as to achieve an economically efficient enforcement process, while at the same time protecting the grantor and other

interested parties against actions taken by the secured creditor that, in the commercial context, are not reasonable. This Guide recommends that, in order to maximize flexibility in enforcement and thereby to obtain the highest possible price upon disposition, creditors should have the option of proceeding either judicially or extrajudicially when enforcing their security rights (see recommendation 139). In any event, in States that permit extrajudicial enforcement, the courts are always available to ensure that legitimate claims and defences of the grantor and other parties with rights in the encumbered assets are recognized and protected (see recommendation 134).

32. Even in States where a secured creditor is permitted to act without official intervention, it is normally also entitled to enforce its security right through the courts. Moreover, because a security right is granted in order to enhance the likelihood of a creditor receiving payment of the secured obligation, post-default enforcement of the security right should not preclude a secured creditor from attempting to enforce the secured obligation by ordinary judicial process (see recommendation 141). There are a number of reasons why a secured creditor might choose either of these options over extrajudicial enforcement. The secured creditor may wish to avoid the risk of having its actions challenged after the fact, or it may conclude that it will have to apply for a judicial proceeding anyway in order to recover an anticipated deficiency, or it may fear a breach of the public order at the time of enforcement. Many States actually encourage secured creditors to use the courts by providing for less costly and more expeditious enforcement proceedings. They may, for example, permit enforcement through a process involving only affidavit evidence. They may also provide for rules ensuring that the hearing must be held, challenges disposed of within a very short time period (e.g. 72 hours) and a decision rendered as expeditiously as possible. Some States even permit a secured creditor that has obtained judgement in the ordinary way to seize and dispose of the encumbered assets without having to use the official seizure and sale process. Finally, most States provide that these recourses are cumulative. A secured creditor that elects to pursue a particular extrajudicial remedy may change its mind and later pursue another extrajudicial remedy to enforce its security rights to the extent that the exercise of a right does not make the exercise of another right impossible (see recommendation 140 and paragraphs 33 and 34 below).

(i) Post-default rights cumulative

33. It will sometimes happen that, in order to dispose completely of all the encumbered assets, a creditor will be obliged to exercise more than one remedy. As noted, this typically occurs when a secured creditor liquidates a business. However, it may occur because, for example, security in inventory may be most effectively enforced through a sale, or security in equipment may be most efficiently enforced through the acquisition of the assets by the secured creditor in satisfaction of the secured obligation. In addition, there will occasionally be situations where a secured creditor believes that one remedy will be optimal, only to discover that another will generate a higher value upon disposition. This is why most States provide that a secured creditor's remedies are cumulative. This means that the enforcing creditor may not only have the option of selecting which remedy to pursue, it may exercise different remedies either at the same time or one after the other. It may even concurrently pursue both judicial and extrajudicial remedies. Only where the exercise of one remedy (e.g. repossession and disposition of an encumbered asset) makes it impossible to exercise another remedy (e.g. acquisition of an encumbered asset in satisfaction of the secured obligation) will the creditor not be able to

cumulate remedies. Here also, the Guide adopts the policy that maximizing flexibility in enforcement is likely to ensure that the highest value is received for the encumbered assets and recommends that secured creditors be permitted to cumulate their judicial and extrajudicial remedies (see recommendation 140).

34. A security right is granted in order to enhance the likelihood of a creditor receiving payment of the secured obligation. The various post-default enforcement remedies, and especially extrajudicial remedies of the secured creditor, are meant to achieve this objective. Some States do not permit secured creditors to cumulate both their (judicial or extrajudicial) remedies with respect to the encumbered assets and their remedies with respect to the secured obligations. The assumption is that the extrajudicial remedies are a favour given to the secured creditor and that the creditor ought, therefore, to be required to opt either to enforce the security right extrajudicially or bring a judicial action to enforce the secured obligation. Other States permit the secured creditor to cumulate both its extrajudicial remedies and its right to enforce the obligation as a matter of contract law. Moreover, they permit the two proceedings to be brought concurrently or serially in either order. To require a secured creditor to opt, at the outset of enforcement, for one or the other mode of proceeding will complicate and increase the cost of enforcement because it will require a creditor to determine if a deficiency is likely to result. If the secured creditor comes to that conclusion, it will be obliged to bring an action to enforce the obligation and assert its priority only at the moment of a judicial sale in enforcement. This process is less expeditious, more costly and will normally produce less value at the time of sale. To maximize enforcement value, the Guide recommends that secured creditors be permitted to cumulate proceedings to enforce the security extrajudicially and to enforce the secured obligation through a judicial process, subject always to the limitation that the secured creditor cannot claim more than it is owed (see recommendation 141).

(j) Right of the secured creditor with priority to take over enforcement

35. The secured creditor that has a higher priority will often wish to take over an enforcement process commenced by another creditor (whether this is under judgement enforcement proceedings or enforcement being pursued by another creditor exercising a security right). States usually provide for a takeover right from secured creditors enforcing under secured transactions law, but some do not permit secured creditors to pursue extrajudicial enforcement once a judgement creditor (whether an unsecured judgement creditor, or a secured creditor that may have also taken judicial enforcement proceedings) has seized the encumbered assets. Where a takeover right is given to a secured creditor against enforcement by a judgement creditor, States often require the secured creditor to exercise the right in a timely manner (i.e. before the auction begins) and to reimburse the judgement creditor for enforcement expenses incurred up to that moment. In order to maximize the efficiency of the enforcement of security rights, the Guide recommends that a secured creditor with a priority ranking higher than that of the enforcing secured creditor is entitled to take control of enforcement both against other secured creditors pursuing extrajudicial enforcement and as against judgement creditors (see recommendation 142).

3. Procedural steps preceding enforcement and the rights of the grantor

(a) General

36. States have developed procedural mechanisms to facilitate effective and efficient enforcement by the secured creditor and protection of the rights of the grantor and third parties with a right in the encumbered assets. Generally, a secured creditor may: (a) obtain a judgement in the regular way, have a public official seize the encumbered assets and sell them at a public auction; (b) exercise an expedited judicial remedy to have the debtor's default acknowledged and proceed immediately to have a public official seize and sell the encumbered assets; or (c) enforce its rights without judicial process. These procedural mechanisms are meant to ensure a balance between competing rights after default but prior to the effective exercise of the secured creditor's remedies. For this reason, States usually provide that these procedural mechanisms apply regardless of the particular remedy selected by the secured creditor. This means that they would apply whether the secured creditor: (a) seizes and sells the encumbered assets privately, appropriating the proceeds of sale to the repayment of the outstanding obligation; (b) acquires the encumbered asset in payment of the secured obligation; or (c) takes over the debtor's business and operates it to pay the secured obligation.

(b) Notice of intended extrajudicial enforcement

37. Where a secured creditor elects to enforce the security agreement by bringing before the courts an ordinary action against the grantor with respect to the secured obligation, the normal rules of civil procedure (including those relating to notice of default and the opportunity for a hearing on the merits) will apply to both the judicial action itself and the post-judgement enforcement process. Usually, however, these rules only apply directly to the formal processes of courts. This is why States that permit extrajudicial enforcement typically enact separate rules governing extrajudicial enforcement. These rules are designed to ensure that the rights of affected parties are adequately protected while at the same time providing for a maximum of flexibility in the enforcement process.

38. The acknowledged need for a notice of extrajudicial enforcement confronts States with a fundamental policy choice. In some States, a secured creditor must give an advance notice of its intention to pursue extrajudicial enforcement even before seeking to obtain possession of the encumbered assets. This means that the creditor must provide the grantor (and usually also third parties with a right in the encumbered assets) a written notice specifying the default, the encumbered assets, the creditor's intention to demand possession of the assets, the time period within which the grantor must either remedy the default or surrender the assets (typically 15-20 days) and, frequently, also the particular remedy that the creditor intends to follow in disposing of them. In other States, the timing of the notice is deferred and its substantive content is often less detailed. For example, in these States the secured creditor is not required to give prior notice of its intention to take possession, but is entitled to immediate possession of the encumbered assets at the same time that it gives formal notice of default to the grantor. Once in possession, however, the secured creditor usually may not dispose of the assets without giving the grantor and interested third parties an advance notice (typically 15-20 days) of the mode and manner of disposition that it proposes to follow if the grantor fails to remedy the default in the interim.

39. There are advantages and disadvantages to both of these approaches. The principal advantage of a regime that requires a prior notice of the secured creditor's intention to enforce and take possession of the encumbered assets is that it alerts the grantor and debtor to the need to protect their rights in the encumbered assets (invariably the debtor will be aware of its default but the third-party grantor may not be). This might involve, for example, challenging the enforcement, curing the debtor's default or seeking potential buyers for the encumbered assets. Notice to other interested parties allows them to monitor subsequent enforcement by the secured creditor, to contest the enforcement, or, if it is in their interest, to cure the default and, if they are secured creditors whose rights have priority (and the grantor is in default towards them as well), to participate in or take control of the enforcement process. The disadvantages of this type of notice include its cost, the fact that the secured creditor may have to elect a remedy before close inspection of the encumbered assets, the opportunity it provides an uncooperative grantor to remove the encumbered assets from the creditor's reach, and the possibility that other creditors will race to assert claims against the grantor's business and interfere with the disposition process. Moreover, unless formal and substantive requirements with respect to notices are clear and simple, there is a risk of "technical" non-compliance that will then generate litigation and its attendant cost and delay.

40. The advantage of a regime that requires only notice of extrajudicial disposition of the encumbered assets is that it secures the right of the secured creditor to take possession of the encumbered assets without undue delay, while protecting the interests of the grantor and third parties with rights in the encumbered assets at the time prior to disposition. The disadvantage is that the grantor is given notice of extrajudicial enforcement after the secured creditor takes possession of the encumbered assets (this approach creates the problems mentioned in the preceding paragraph).

41. Regardless of which approach is taken, States must also decide what other notices may be required when a secured creditor seeks to enforce its security right extrajudicially. Many States that require a prior notice of intended disposition of the encumbered assets do not also require a separate notice of default or a subsequent notice of extrajudicial enforcement. The assumption is that a single notice will be sufficient for all purposes. Other States that permit the notice of the specific extrajudicial enforcement method being pursued to be given after the creditor obtains possession of the encumbered assets, nonetheless require a pre-possession formal notice of default. Because the objective and contents of the pre-possession notice of intention to enforce and the post-possession notice of extrajudicial enforcement largely overlap, no States that opt for the former also require the latter. To balance the interests of all parties, the Guide recommends that the secured creditor may take possession of the encumbered assets without applying to a court, provided that the grantor has consented to extrajudicial enforcement in the security agreement, does not object when the secured creditor seeks to obtain possession, and the secured creditor has given the grantor notice of default and of its intention to seek to obtain possession out of court (see recommendation 144).

(c) Form and content of the notice

42. As with other situations where notice may be required, States usually specify with considerable care the manner in which the notice is to be given, the persons to whom it must be given, the timing of the notice and its minimum contents. Many States distinguish between notice to the debtor, notice to the grantor when the

grantor is not the debtor, notice to other creditors and notice to public authorities or the public in general. It is a matter of a cost-benefit analysis whether the secured creditor should be required to give prior written notice to others beyond the debtor and grantor and other secured creditors known to exist (i.e. other secured creditors that have registered a notice of their rights or that have otherwise notified the secured creditor that proposes to dispose of the encumbered assets). Some States provide that the notice need be given only to the grantor and other secured creditors that have registered their rights, but that it then be registered and that thereafter the registrar be required to forward the notice to all third parties other than secured creditors that have registered rights against the encumbered assets. Other States only require the secured creditor to give notice to the grantor and to register the notice. These States impose on the registrar the duty to send the notice to other parties.

43. States also take different approaches to the minimum content of the notice. As with the decision about the timing of the notice and its recipients, decisions about the information to be included require States to undertake a cost-benefit analysis. For example, they usually require the inclusion of the secured creditor's calculation of the amount owed as a consequence of default. They might further require advice to the debtor or grantor regarding what steps to take to pay the secured obligation in full or, if such a right exists, to cure the default. Moreover, some States provide that the notice to other interested parties need not be as extensive or specific as notice to the debtor and grantor. Again, where the notice is to be given prior to taking possession, States sometimes place a higher information burden on secured creditors. Where the notice is given after possession, by contrast, the secured creditor is often obliged simply to provide basic information about the date, time, location and type of disposition being proposed and the time period within which the grantor or other interested party may contest the proposal or remedy the default.

44. There are different approaches to achieving the right balance between the need to ensure that the notice conveys to interested parties sufficient information to enable them to make an informed judgement about how best to protect their rights, and the need to achieve expeditious and low-cost enforcement. Some States place a heavy burden on secured creditors, both as to the timing and the content of the notice. Others impose only minimal requirements. The Guide recommends that this notice must be given prior to obtaining possession (see recommendation 144). If the secured creditor is already in possession, this notice need not be given. Nonetheless, in either case the creditor must inform the grantor of the intended manner of realizing upon the encumbered assets. If the proposed remedy is extrajudicial sale, the notice will be given, except in cases of urgency prior to disposition of the encumbered assets (see recommendation 146). While the secured transactions law should provide for the notice to be given in a timely, efficient and reliable way (see recommendation 147), the Guide recommends that States have the flexibility to determine the specific manner for giving the notice and its specific contents (see recommendation 147). In a like manner, the Guide recommends that, if the secured creditor exercises the remedy to acquire the encumbered asset in full or partial satisfaction of the debt (see recommendation 153), the notice must permit the grantor sufficient time to object to the proposal (see recommendation 154).

(d) Authorized disposition by the grantor

45. Following default, the secured creditor will be interested in obtaining the highest price possible for the encumbered assets. Frequently, the grantor will be more knowledgeable about the market for the assets than the secured creditor.

For this reason, secured creditors will often permit the grantor to dispose of the encumbered assets even after enforcement has commenced. In most such cases, the parties agree that any amount received from the disposition will be paid to the secured creditor in the same manner as if payment resulted from enforcement proceedings. These arrangements have consequences for third parties that may also have rights in the encumbered assets, or a right to proceeds of their disposition. For this reason, some States explicitly provide that when a secured creditor that has commenced enforcement gives the grantor a limited time following default to dispose of the encumbered assets, the proceeds of the sale will, for all purposes, be treated as if they had arisen as a consequence of an enforcement disposition. Some States go further, and even prohibit the secured creditor from attempting to arrange for the disposition of the encumbered assets during a short period of time following default. Other States seek to achieve the objective of maximizing the amount received upon disposition by providing incentives for the grantor to bring potential buyers to the attention of the secured creditor. In any event, the point is: (a) to structure the enforcement regime so as to give the grantor the incentive to cooperate with the secured creditor in disposing of encumbered assets for the highest possible price; and (b) to give the secured creditor the incentive to seek the highest possible price even when this exceeds the amount still owing on the obligation secured by the encumbered asset.

4. Extrajudicial enforcement of the rights of the secured creditor

(a) General

46. In cases where a secured creditor elects to enforce the security agreement judicially, after judgement has been obtained, it will be necessary for the secured creditor to seize and sell the encumbered assets. In some States, the normal rules of civil procedure relating to the post-judgement enforcement process will apply. Typically, this means that public officials or authorities (e.g. bailiffs, sheriffs, notaries or the police) will take possession of the encumbered assets and sell them in a public auction. In other States, even after a secured creditor has obtained judgement, it may exercise its extrajudicial right to take possession of the encumbered assets and proceed to dispose of these assets extrajudicially. In still other States, once judgement has been obtained, the secured creditor must follow a judicial process, but a streamlined procedure for enforcing the judgement is provided.

47. Slightly different processes are required where a secured creditor has taken the steps that are necessary to commence enforcement proceedings and elects to proceed with extrajudicial enforcement. As no public official is involved, the secured creditor will normally wish to, and typically will have to, obtain possession or control of the encumbered asset itself in order to proceed with enforcement. States have taken different policy approaches both to the right of the secured creditor to obtain possession and control of assets (as opposed to consigning encumbered assets to a bailiff) and, if direct creditor possession is permitted, to the procedural mechanisms that must be followed for doing so.

(b) Removing the encumbered assets from the grantor's possession

48. Prior to default, the grantor will usually be in possession of the encumbered assets. Sometimes, however, the grantor will have already placed the secured creditor in possession, either at the time of making the security right effective

between them (see recommendation 15) or thereafter either as a means of achieving third-party effectiveness (see recommendation 37) or in response to a later pre-default creditor request to take possession of the assets. On other occasions, the encumbered assets may be in the possession of a third party that is acting for, or under the direction of, the secured creditor. In both these situations, many States do not require the secured creditor to take any further steps in order to commence enforcement. That is, the creditor need not formally give the grantor notice of default, but need only send a notice of intended disposition once it has determined the recourse it intends to pursue. By contrast, some States require the creditor in possession to inform the grantor of the default and of the fact that it is now holding the encumbered assets in preparation for enforcement. These States usually also consider that, upon default, any agreement under which the creditor in possession may use the encumbered assets comes to an end.

49. Where the creditor is not in possession, it must take active steps to recover the encumbered assets from the grantor or to inform a third party holding on behalf of the grantor that the security right has become enforceable. States that provide for extrajudicial enforcement generally provide that, once a grantor is in default, the secured creditor has an automatic right to possession of the encumbered asset. This means that they do not require that, pending extrajudicial enforcement, the assets be placed under the control of a public official. The assumption is that flexibility in enforcement and preservation of the assets at a lower cost pending disposition will result if the secured creditor can make decisions about where post-default possession should lie. This rationale also underlies the recommendation in the Guide that the secured creditor has upon default an automatic right to possession (see recommendation 143).

50. A concomitant of the secured creditor's right to possession is its right to decide exactly how the rights flowing from that possession should be exercised. In some cases, secured creditors will themselves take physical possession of the encumbered assets against which they are proceeding. However, in many cases, they will not take possession of the assets. Secured creditors may, for example, have the assets placed in the hands of a court, or a State- or court-appointed official. More commonly, they will have the assets entrusted to a third-party depositary that they appoint, or (particularly in the case where a manufacturing operation is involved) will appoint a manager to enter into the premises of the grantor in order to take possession of the encumbered assets. Where assets are already in the hands of a third party that is not acting for them, but that has previously been made aware of the security agreement, secured creditors may simply give notice that the agreement has become enforceable and that the grantor no longer has rights to retain possession, to control or to dispose of the encumbered assets.

51. States usually consider the taking of possession of encumbered assets by secured creditors to be a significant step in the enforcement process and impose specific procedural requirements on creditors claiming possession. This means that, even though the secured creditor may have an automatic right to possession, the manner for doing so is regulated. In general, States take one of three approaches in developing the procedural mechanisms by which secured creditors not in possession may take possession of encumbered assets. In some States, the secured creditor may only obtain possession by a court order, whether following an *ex parte* procedure, or more frequently, after a hearing. In other States, no judicial order is required, but the grantor must have authorized the creditor to obtain possession extrajudicially in the security agreement and the creditor must give the grantor a prior notice

(typically 10 or 20 days) of its intention to claim possession and to enforce. Finally, in some States, the creditor is entitled to demand and to take possession without any recourse to a court and without the need to give the grantor a prior notice of its intention to do so, provided that the grantor authorized it to do so in the security agreement (see para. 38 above). Even in these States however, the creditor does not have an absolute right to obtain possession extrajudicially. There is always potential for the creditor abusing its rights by threatening the grantor, intimidation, breaching the peace or claiming the encumbered assets under false pretences. Most of these States, therefore, condition any acts of the creditor to obtain possession on the creditor avoiding a disturbance of the public order. Should the grantor resist, a judicial order for possession would be required. States that permit extrajudicial creditor possession upon the giving of a 10- or 20-day prior notice typically also adopt this approach to possession and require a judicial order if a breach of the peace is threatened when the creditor seeks possession after the delay has expired.

52. As mentioned above (see paras. 39-41), in States that impose a notice requirement on secured creditors as a precondition to obtaining possession, there is always a risk that a grantor in default may then seek to hide or transfer the encumbered asset before the secured creditor can take control of it. It may also be that the assets may be misused, may dissipate if not looked after or, depending on market conditions, may rapidly decline in value. To forestall these possibilities, most States provide that secured creditors may obtain expedited relief from a court or other relevant authority. Furthermore, in the special case where the encumbered assets threaten to decline rapidly in value, and whether or not secured creditors are required to give a prior notice of their intention to enforce, many States permit the court to order the immediate sale of these perishable assets.

53. The decision as to the formalities required in order for a secured creditor to obtain possession depends on the balance States strike between the protection of the rights of grantors and efficient enforcement to reduce costs. It also depends on a judgement as to the likelihood in practice of abuse by secured creditors or improper behaviour by grantors in possession. In order to reduce the cost of enforcement and minimize the chances that assets will be misused or dissipate in value, the Guide recommends that the secured creditor be authorized to obtain possession extrajudicially, but only if the grantor has so consented in the security agreement, a notice of intention to take possession has been given to the grantor, and the grantor does not object at the time possession is being sought (see recommendation 144). In addition, the Guide recommends that notice of the creditor's intention to take possession and to dispose of the assets need not be given where assets are perishable or are likely to decline rapidly in value during the period between the giving of notice and the time when the creditor may actually obtain possession of the assets (see recommendation 146). However, for the secured creditor to have this remedy, the grantor must have authorized extrajudicial possession in the security agreement and have no objection when possession is actually being sought (see recommendation 144).

(c) Sale or other disposition of the encumbered assets

54. As a security right entitles the secured creditor to obtain the value from the sale of the encumbered assets and to apply it to the secured obligation, States usually regulate in some detail the procedures by which the secured creditor may seize and dispose of these assets. Requirements range from the less to the more formal. For example, even when extrajudicial enforcement is permitted, some States

require disposition to be subject to the same public procedures used to enforce court judgements. Other States require secured creditors to obtain judicial approval of the proposed mode of disposition before proceeding. Still other States permit the secured creditor to control the disposition but prescribe uniform procedures for doing so (e.g. rules relating to public auctions or a call for tenders). On occasion, States actually oblige the secured creditor to obtain the consent of the grantor as to the mode of disposition. Finally, some States give the secured creditor a wide, unilateral discretion as to the mode of disposition, but subject this conduct to general standards of conduct (e.g. good faith and commercial reasonableness), the breach of which leads to the creditor's liability in compensatory damages.

55. Most commonly, the procedural safeguards by which States control the actions of secured creditors relate to the details of the notice that must be given to the grantor and third parties with a right in the encumbered assets. In principle, the types of detail required should be identical whether States opt for a pre-possession notice approach or a post-possession notice approach. So, for example, States often require creditors to indicate the method of advertising a proposed disposition, the date, time and location of the sale, whether the sale will be by public auction or by tender, whether the assets will be sold individually, by lot or as a whole, and whether the disposition includes leases, licences or associated permits where required. The objective should be to maximize the amount realized for the encumbered assets, while not jeopardizing the legitimate claims and defences of the grantor and other persons. This explains why even States that generally require detailed notices do not do so when the encumbered assets are to be sold on a recognized public market. In such cases, the market sets the value of the assets and there is no higher price to be obtained by adopting and giving notice of some other mode of sale (see recommendation 146).

56. As an extrajudicial disposition of encumbered assets has the same finality as a court-supervised sale, most States not only impose relatively detailed rules as to the contents of the notice and the time that must elapse before the sale can take place, but also permit interested parties to object to the timing and manner of the proposed disposition. Typically, special expedited procedures are available so that objections may be quickly heard and dealt with (see recommendations 134 and 135). As a general rule, where the enforcing creditor has the greatest flexibility as to timing and method of disposition, the cost of enforcement is lowest, the enforcement is most expeditious and the proceeds received are highest. For these reasons, the Guide recommends flexibility for secured creditors and only the basic minimum of detail in the notice necessary to alert interested parties to the enforcement and the need to protect their interests should they wish (see recommendations 147 and 148).

(d) Allocation of proceeds of disposition

57. One of the important features of secured transactions law is that it disrupts the normal rules for distributing the proceeds of disposition that apply as between unsecured judgement creditors. After all, the object of the security is to obtain a priority in the distribution of these proceeds. Should the enforcement of the security right have taken place judicially or should the secured creditor not have taken over an enforcement process brought by a judgement creditor, the proceeds will be held by a public authority pending their distribution to parties entitled to them. When the regime provides for a purge of rights, the most common allocation is to pay reasonable enforcement costs first and then the secured obligations in the order of their priority. Many States also provide for the payment of certain statutory claims,

after costs of enforcement but in priority to secured creditors. If the ordinary enforcement process does not provide for a purge of rights, secured creditors will not receive payment, but will be able to assert their security rights against the purchaser.

58. Where a secured creditor enforces through an extrajudicial sale, States typically provide in their secured transactions law a series of rules relating to the proceeds of the sale. Often there are special rules dealing with the manner by which proceeds are to be held by the secured creditor pending distribution. These rules usually also prescribe if and when a secured creditor is responsible for distributing proceeds to some or all other creditors (such as secured creditors with security rights in the encumbered assets with a lower priority ranking than that of the enforcing secured creditor or, if the enforcement regime provides for a purge of rights, to secured creditors with a higher priority ranking and statutory priority claimants). Often, the secured creditor need only take account of these other rights if they are registered or have otherwise been made effective against third parties, or if it has been expressly notified of them (e.g. the case of statutory priority claims that need not be registered). Invariably States also provide that any surplus proceeds after all creditors entitled to payment have been satisfied are to be remitted to the grantor (see recommendation 149).

59. The secured obligation is discharged only to the extent of the proceeds received from the sale of the encumbered assets. Normally, the secured creditor is then entitled to recover the amount of the deficiency from the grantor. Unless the grantor has created a security right in other assets for the benefit of the creditor, the creditor's claim for the deficiency is an unsecured claim. Regardless of whether there is a deficiency or a surplus, some States provide that, when a secured creditor purchases the encumbered assets at an enforcement sale and later sells them at a profit, the amount received for the sale that exceeds the amount paid by the creditor and the costs of the further sale, is deemed to be received in satisfaction of the secured obligation. Generally, however, unless the initial sale can be shown to have been commercially unreasonable, States consider the amount generated to be the final value received upon disposition of the encumbered assets.

(e) Acquisition of the encumbered assets in satisfaction of the secured obligation

60. The underlying rationale for creating a security right is to enable the secured creditor to realize the value of the encumbered asset and to apply the money received to payment of the grantor's obligation. For this reason, in many States, a creditor's only recourse upon default is to seize the encumbered assets and sell them. In most States that so limit the secured creditor's extrajudicial remedies, the limitation applies even when the creditor is already in possession of the encumbered assets under a security agreement. That is, in these States it is not possible for the parties to agree in advance that, should the grantor default, the secured creditor may keep the encumbered assets in satisfaction of the secured obligation. Similarly, in many of these States, the secured creditor may not take the encumbered assets as a remedy after default has occurred. Moreover, even if, after default, the grantor and the secured creditor agree that the secured creditor may keep the encumbered assets, in these same States such arrangements are considered as a contractual payment and have no effect on the rights of any other party with a right in the encumbered assets.

61. By contrast, in many States, the secured creditor is entitled to propose to the grantor that it acquire the encumbered assets in full or partial satisfaction of the secured obligation. Where such an enforcement remedy is made available to secured

creditors, States usually provide that any agreement that automatically vests ownership of the encumbered assets in the secured creditor upon default is unenforceable if entered into prior to default. However, the agreement is enforceable if made after default and according to the specific enforcement procedures meant to prevent creditor abuse. These States usually also provide that any informal private agreements entered into by grantors and secured creditors after default are enforceable, but only as contractual payment remedies that have no effect on third parties with rights in the encumbered assets.

62. Where States expressly permit the creditor to take the encumbered assets in satisfaction of the secured obligation after default, provided that it has followed the required procedural steps, this does not mean that the grantor must accept the secured creditor's offer. The grantor may refuse to do so, with the consequence that the secured creditor will have to pursue one of its other remedies. The advantage of permitting these types of post-default agreement is that they can often lead to less expensive and more expeditious enforcement. The disadvantage is that there may be a risk of abuse by the secured creditor in cases where: (a) the encumbered assets are more valuable than the secured obligation; (b) the secured creditor has, even in the post-default situation, unusual power over the grantor; or (c) the secured creditor and the grantor come to an arrangement that unreasonably prejudices the rights of third persons with a right in the encumbered assets.

63. To guard against the potential for abusive or collusive behaviour by the secured creditor and the grantor, some States require not only the consent of the grantor to the acquisition by the secured creditor, but also that notice be given to third parties with rights in the encumbered assets. These third parties then have a right to object to the proposed agreement and may require the secured creditor to enforce the security by means of a sale. In addition, some States require the consent of a court under certain circumstances, such as where the grantor has paid a substantial portion of the secured obligation and the value of the encumbered assets greatly exceeds the outstanding obligation. Finally, some States require that a secured creditor that proposes to acquire encumbered assets in satisfaction of the secured obligation be required to provide an official and independent appraisal of the value of the encumbered assets before proceeding.

64. Whether States should impose any or all of these requirements, and especially the requirement of prior judicial involvement, will depend on their assessment of the costs and benefits of each requirement. In line with the general objective of maximizing flexibility so as to obtain the highest possible value for encumbered assets at the point of enforcement, the Guide recommends that either the secured creditor or the grantor may propose to the other that the assets be taken in satisfaction of the secured obligation (see recommendations 153 and 156). Likewise, to ensure that all parties understand the full implications of the proposal, the Guide recommends that adequate notice of the secured creditor's intention to acquire the assets in payment is given to the grantor and third parties, and that the notice indicates not only the assets to be taken in satisfaction, but also the amount owed at the time the notice is sent, the amount of that obligation that is proposed to be satisfied by the acquisition, and a relatively short period of time at the expiration of which the proposal will be deemed to be accepted by the grantor and third parties (see recommendation 154). The assumption is that requiring the secured creditor to indicate its own valuation of the encumbered assets is a more efficient and less costly mechanism for providing relevant information to interested parties than providing for an independent appraisal. It is also assumed that, once informed of the

secured creditor's proposal, the grantor or third parties will be in a position to assess its reasonableness. This is the reason why the Guide further recommends that the grantor or third parties be given a right to object to the secured creditor's acquisition of the encumbered assets. The consequence of a timely objection is that the secured creditor must abandon this remedy and exercise another of its remedies, i.e. typically an extrajudicial sale or other disposition (see recommendation 155).

(f) Management and sale of a business

65. In many circumstances, a secured creditor has security not just on specific assets of a grantor, but on most or all of the assets of a business. In these situations, the highest enforcement value can often be obtained if the business is sold as a going concern. In order to be able to do so efficiently, secured creditors must usually be able to dispose of all these assets, including immovable property. Moreover, in such cases, States often prescribe special notice procedures for the sale and more strictly regulate the conditions under which the sale of a business as a going concern may take place.

66. Alternatively, in many cases where enforcement becomes necessary, it is not in the interest of the grantor or the secured creditor to immediately dispose of all the assets of a business, whether these are sold by category (e.g. inventory, equipment and licences) or whether the business is sold as a whole. For this reason, many States permit secured creditors to take possession of business operations and manage the business for a certain period of time after default. Frequently, these States require that the notice of enforcement specifically indicate that when the creditor takes possession of the encumbered assets it intends to gradually wind down the business. This is especially important for other creditors that otherwise may not know that liquidation is taking place. Some States also prescribe special procedures for naming a manager, for operating the business, for alerting suppliers of the secured creditor's rights and for informing customers that what looks like an ordinary-course-of-business sale is in fact part of an enforcement process.

67. When inventory has been effectively liquidated, the secured creditor will typically proceed to exercise another of its remedies. In such cases, most States require the secured creditor to give a further notice to the grantor and other parties with a right in the remaining assets (most often equipment, leases, licences and a remnant of inventory) that it proposes to exercise another of its remedies (e.g. acquiring the assets in satisfaction, or more commonly, selling them). Once such a notice is given, then the regular enforcement procedures applicable to that recourse will apply. Although many States now permit creditors to take over the management of a business for the purposes of gradually liquidating its inventory and equipment, the Guide does not make a formal recommendation on this point. States interested in this remedy may have to weigh the benefits against the responsibilities associated with management of a business by a secured creditor, as well as the impact of such a remedy on the rights of other creditors, secured or unsecured.

5. Effects of enforcement

(a) The grantor, the secured creditor and third parties

68. In order to make the enforcement regime as expeditious as possible, States typically enact detailed rules that determine the effect of enforcement on the relationship between the grantor and the secured creditor, the rights of parties that

may purchase the encumbered assets at an enforcement sale, and the rights of other secured creditors to receive the proceeds generated by the sale of the encumbered assets. The primary object of an enforcement procedure is to generate value for the secured creditor that can be deployed to satisfy the unpaid secured obligation. In the most common situation, the secured creditor will acquire this value by selling the encumbered assets and appropriating the proceeds. Should there be a surplus, the secured creditor must return it to the grantor or to any other person entitled to it. Moreover, as just noted, should there be a deficiency, most States provide that the secured creditor retains an ordinary contractual right to sue the grantor for the deficiency as an unsecured creditor. The details of how proceeds of disposition are normally allocated in these cases have already been discussed (see paras. 57-59 above).

69. As noted, however, sometimes the secured creditor will acquire the encumbered asset in satisfaction of the secured obligation. Not all States adopt identical rules to govern the effects of this particular remedy. Usually, States provide that the creditor that acquires the asset in satisfaction may keep it, even where the value of the asset exceeds the amount of the secured obligation still owed. This means that, unlike the case of a sale, the secured creditor may keep a surplus. Concomitantly, many of these States provide that the secured creditor that acquires the asset in satisfaction of the obligation has no recourse for a deficiency against the grantor. The acquisition is deemed to be complete payment and therefore extinguishes the secured obligation. By contrast, however, other States permit creditors that have taken encumbered assets in satisfaction of the secured obligation to pursue their grantor for a deficiency. In these cases, it becomes necessary to establish the value of the assets being taken in satisfaction so that the amount of the deficiency may be calculated. Some States require the secured creditor to provide an independent accounting of the value of these assets taken, while other States merely require the secured creditor to indicate the value that it ascribes to these assets. In either case, as noted, the grantor or other creditor may require the secured creditor to sell the asset instead. For reasons already given (see para. 64 above), the Guide recommends that secured creditors may take the asset in total or partial satisfaction of the secured obligation, provided that they indicate the value they ascribe to it in the notice sent to the grantor and third parties (see recommendation 154).

(b) Other parties

70. When a secured creditor enforces its security right by means of a sale of the encumbered assets, there are different approaches to determining the effects of the sale on other parties. In some States, the sale (even when it is an extrajudicial sale) will extinguish all security rights in the encumbered assets. In such cases, even secured creditors with a priority ranking higher than that of the enforcing secured creditor will lose their security rights and will only have a claim in the proceeds with an equivalent priority ranking. Parties that purchase the assets will obtain a clear title and, it is presumed, will be willing to pay a premium to do so. In other States, the sale by a creditor (whether it is managed by a judicial officer or it is a private sale by the creditor) will only extinguish rights with a lower priority ranking than that of the enforcing secured creditor and the secured creditor with a higher priority ranking will retain its security right in the encumbered assets. Purchasers at the sale will not obtain a clear title and will, consequently, discount the amount they offer for the assets being sold. The assumption is that the highest ranking secured creditor normally will either take over the enforcement (so that all security rights will be extinguished) or that a lower ranking secured creditor will arrange to pay off

the higher ranking creditor so as to produce a clear title. While either approach usually will produce a clear title, the second approach maximizes the flexibility of the enforcing creditor and the purchaser to reach an alternative arrangement in the event that the purchaser cannot finance the entire cost of the secured asset and is willing to purchase it for a discounted price because it is subject to a higher ranking security right. To maximize flexibility and efficiency in enforcement, the Guide recommends adoption of the second approach with respect to extrajudicial dispositions (see recommendations 158-160). As to judicial dispositions, to avoid interference with general rules of civil procedure governing execution proceedings, the Guide leaves the matters to other law (see recommendation 157).

71. When a secured creditor acquires the encumbered assets in satisfaction of the secured obligation, States usually provide that the secured creditor acquires the assets as if they were transferred through an enforcement sale. While it is possible that States could provide that an acquisition in satisfaction of the secured obligation operates a purge of all rights, this would invariably lead secured creditors with a higher priority ranking than that of the enforcing secured creditor to take over the enforcement process. Therefore, most States provide that the rights of other secured creditors are determined by their priority relative to the enforcing creditor. So, for example, where a State permits a secured creditor to take an encumbered asset in satisfaction of the secured obligation, that creditor will acquire the asset subject to the rights of secured creditors with a higher priority ranking. Conversely, if there are secured creditors with even lower priority, their rights will normally be extinguished upon acquisition of the encumbered assets by a secured creditor with higher priority. For the same reasons that apply to the remedy of extrajudicial sale, the Guide recommends that the secured creditor that acquires the asset in satisfaction takes it free of lower priority security rights, but subject to the rights of secured creditors with a higher priority (see recommendation 158).

(c) Finality

72. Secured transactions laws normally provide finality following enforcement. This means that, once the sale or acceptance in satisfaction has taken place according to the required enforcement procedures, it normally cannot be reopened. Unless fraud, bad faith or collusion between seller and buyer can be proved, the sale is final. Whether the secured creditor accepts the encumbered asset in satisfaction of the secured obligation or whether the assets are sold to a third party that acquires them at an enforcement sale, the effects of the enforcement on other parties are usually the same. The security right of the enforcing secured creditor terminates, as do the grantor's rights and the rights of any secured creditor or other person with a lower priority ranking in the assets. In States where the sale produces a total purge of rights in the encumbered assets, the purchaser or the creditor that takes the encumbered assets in satisfaction of the secured obligation obtains a clear title. Most often, however, the law provides that the rights of certain other persons in the encumbered assets (most notably secured creditors with a higher priority ranking than that of the enforcing secured creditor) continue notwithstanding disposition of the assets in the enforcement procedure.

6. Enforcement of a security right in proceeds

73. If the grantor sells the encumbered assets (in particular with the authorization of the secured creditor, in which case the security right does not continue in the encumbered assets; see recommendation 77, subparagraph (a)), the proceeds of the

sale take the place of the encumbered assets (for the definition of “proceeds”, see Introduction, section B. Terminology). Hence, many States provide that a security right in tangible assets will automatically pass into the proceeds of its disposition. Other States either do not so provide, or require that the security agreement expressly indicate which proceeds will be covered by the security. The Guide recommends that secured creditors have a right to claim their security in proceeds of encumbered assets and proceeds of proceeds (see recommendations 39 and 40). Moreover, unlike many States that limit the concept of proceeds to replacement assets, the Guide considers proceeds to include anything that is received on account of the encumbered asset, any fruits and revenues it generates and the natural increase of animals or plants.

74. Generally, States do not enact separate rules governing the enforcement of security rights in proceeds. This means that enforcement against proceeds will follow whatever type of process is required in order to enforce security against that type of asset (e.g. a tangible asset, a receivable, a negotiable instrument, rights to payment of funds credited to a bank account, and so on). It would create considerable confusion if secured creditors were able to enforce security rights in proceeds according to the rules governing enforcement against the initially encumbered assets when other creditors seeking to enforce security rights against those proceeds as initially encumbered assets would have to follow rules specifically applicable to that type of asset. By not recommending special enforcement rules applicable to proceeds, the Guide implicitly recommends that the general enforcement rules apply also to the enforcement of security rights in proceeds, except if the proceeds are receivables or other specific assets like those mentioned in section B of this chapter. In such cases, the asset-specific enforcement recommendations described therein would apply.

7. Intersection of movable and immovable property enforcement regimes

75. Frequently, the characterization of tangible assets as movable or immovable will change over time, as movable assets become immovable property. For example, construction materials may become fully incorporated into a building, or shrubs and trees, manure and seeds may be planted or tilled into soil, thereby turning into immovable property. Sometimes, the movable asset may be an attachment and not fully incorporated into immovable property (for example, an elevator, a furnace, or an attached counter or display case). In all of these cases, a security right in the movable assets may have been made effective against third parties prior to attachment to or incorporation into the immovable property. The converse situation can also arise. A creditor may seek to take a security right in an asset that is currently immovable property, but is destined to become movable (for example, crops, products of mines and quarries and hydrocarbons).

76. States have enacted many different rules to govern these various situations. A primary concern is to establish the rights of creditors that seek to enforce security rights in movable assets where movable and immovable property enforcement regimes may intersect. Most often, these enforcement regimes depend on the characterization given to the assets. So, for example, many States permit the creation of a security right under secured transactions laws (applicable to movable assets) in movable assets that, while they are part of immovable property, are destined to become movable, but postpone effectiveness until detachment. No enforcement of the security right can take place until the asset becomes movable, and no enforcement of an encumbrance in immovable property may be

taken against assets that have become movable. While the Guide makes no specific recommendation on this question, because the enforcement regime presupposes the separate existence of tangible assets as movable assets such a result implicitly follows.

77. More difficult enforcement questions arise when tangible assets are attached to or incorporated into immovable property. Many States distinguish between construction materials, other movable assets that lose their identity when incorporated into immovable property (such as fertilizer), seeds, and attachments that retain their identity as movable assets. Some States provide that security rights in movable assets that lose their identity may only be preserved if they are made effective against third parties by registration in the immovable property registry, but that security rights in attachments made effective against third parties prior to the attachment retain their effectiveness without further registration. In these States, enforcement against the former kind of assets would always be governed by the rules relating to enforcement against immovable property. Where the movable assets become an attachment, these States usually enact special rules to govern not only the preservation of the secured creditor's rights, but also the preservation of the rights of creditors with rights in the immovable property.

78. The Guide follows the general pattern that many States have adopted for resolving conflicts between creditors with competing rights in attachments. Where tangible assets lose their identity through incorporation into immovable assets, any security right in the movable assets is extinguished. Where, however, the movable assets become an attachment, the security right continues, and its effectiveness against third parties is preserved automatically. The secured creditor may also ensure third-party effectiveness by registration of the security right in the immovable property registry (see recommendations 38 and 42). The enforcement rights of the secured creditor as against the attachment, and in relation to secured creditors that may have security rights in the immovable property, will then depend on the relative priority of the competing rights (see recommendations 84 and 85). If the secured creditor with rights in the attachment has priority, it may detach the assets and enforce its security right as a security right in the movable assets, subject to the right of the secured creditor or other interested party paying the value of the attachment. If, however, detachment of an attachment to immovable property (e.g. an elevator from a building) damages the immovable property (not by diminishing its value), the enforcing secured creditor has to compensate persons with rights in the immovable property. If another creditor with a security right in the immovable property has priority, the secured creditor can enforce its rights only under the regime governing security rights in immovable property, provided that it has maintained effectiveness against third parties by registering in the immovable property registry (see recommendations 161, subparagraph (a), and 162).

79. The enforcement of security rights in attachments to immovable property is further complicated where the secured creditor has taken an encumbrance in the immovable property and a security right in the movable asset that has become an attachment to the immovable property. Most States enable the creditor in such cases to enforce the security in a variety of ways. The creditor may enforce the security right in the attachment and the encumbrance against the rest of the immovable property. Alternatively, the secured creditor may enforce the encumbrance against the entire immovable property, including the attachment. In the former case, the secured creditor would have to have priority over all rights in the immovable property (see recommendation 162). In the latter case, the rights of the creditor

would be determined by the priority regime governing immovable property (see recommendation 161, subparagraph (b)).

8. Enforcement of a security right in an attachment to movable assets, a mass or a product

80. Many types of tangible asset in which a security right has been created are destined either to be attached to other tangible assets, to be manufactured into a product or to be commingled with other tangible assets into a mass. Many States deal with security rights in such cases by rules that determine whether ownership in the attachment, manufactured product or mass has passed to a third party. The Guide recommends that security rights that are effective against third parties generally should continue in assets that have become attached to other assets, in assets that are manufactured or processed into products and in assets that are commingled with other assets into a mass (see recommendations 41-44). Where States permit continued third-party effectiveness of security rights in tangible assets that are attachments, manufactured products or commingled assets, they normally also apply the general rules to enforcement against this type of asset (e.g. automobile engines, manufactured fibreglass products, commingled inventories of clothing, grain in a silo and oil in a tank). The assumption is that it would create unnecessary confusion if an enforcement regime other than that generally applicable were to be enacted.

81. With respect to the enforcement of a security right in an attachment to a movable asset, similar rules apply as in the case of security rights in attachments to immovable property. A secured creditor with a lower priority ranking than that of the enforcing secured creditor may pay off the claim of the enforcing secured creditor; a secured creditor with a higher priority ranking may take over the enforcement process; and the enforcing secured creditor is liable for any damage caused by the act of removal of the attachment. However, the difference with the treatment of a security right in an attachment to immovable property is that a secured creditor does not need to have priority as against competing rights in the movable asset to enforce its security right in the attachment (see recommendations 162 and 163).

82. In cases of products or masses, more than one secured creditor may have rights in the end product and the component assets. If the encumbered assets can be separated (as is the case with masses), the secured creditor with an enforceable security right against only a part of the assets should be able to separate the part in which it has a security right and dispose of that part following the general rules. If the encumbered assets cannot be separated (as is the case with products), the whole product may have to be sold and the rights of competing secured creditors that may have rights in other parts of the commingled assets will be determined by recommendations relating to priority (see recommendations 87-89).

B. Asset-specific remarks

1. General

83. The basic principles governing enforcement of security rights just reviewed ought generally to apply whatever the type of encumbered asset. Nonetheless, they primarily envision certain types of tangible assets, such as inventory, equipment and consumer goods. For this reason, these rules do not easily apply either to the enforcement of security rights in intangible assets, such as receivables and various

payment rights (such as rights to payment of funds credited to a bank account, rights to receive the proceeds under an independent undertaking or payment rights arising from negotiable instruments) and rights to possession arising from a negotiable document (for the definitions of these terms, see Introduction, section B. Terminology). Consequently, many States have enacted special rules governing enforcement against these types of encumbered asset. These rules include, *inter alia*, provisions giving the secured creditor the right to collect from the person obligated on the receivable or negotiable instrument and requiring that person to make payments directly to the secured creditor. Moreover, in many of these cases, secured transactions law accommodates, and in part defers to, the specialized law and commercial practices governing bank accounts, negotiable instruments, negotiable documents and independent undertakings.

2. Enforcement of a security right in a receivable

84. When a security right is taken in a receivable, the encumbered asset is the grantor's right to receive payment from the debtor of the receivable (for the definitions of the terms "receivable", "assignment", "assignor", "assignee" and "debtor of the receivable", see Introduction, section B, Terminology). While it would be theoretically possible to require the assignee to enforce the assignment by seizing the receivable and either selling it or keeping it in satisfaction of the secured obligation, this would be a cumbersome and inefficient way of realizing the economic value of the asset. This is the reason why most States that permit creditors to take security in receivables and other claims, enable the assignee to collect payment directly from the debtor of the receivable once the assignor is in default. The primary concerns are two: first, that the assignor knows that the assignee is enforcing (either after default, or with the agreement of the grantor before default); and second, that the debtor of the receivable knows that it must thereafter make payments to the assignee.

85. In chapter VIII, Rights and obligations of the parties to a security agreement, the Guide discusses the relationship between the assignor, the assignee and the debtor of the receivable. Issues discussed include, for example, the right of the assignee to inform the debtor of the receivable to make payments directly to the assignee following the assignor's default (see recommendations 111-113). The Guide also provides, in chapter IX, Rights and obligations of third-party obligors, *inter alia*, that the debtor of the receivable is protected against having to pay twice by the notification and payment instruction given by the assignee or the assignor (see recommendations 114-120).

86. Many States take the position that the assignee's primary enforcement right is simply to collect the receivable. Assuming that it has followed the steps required to make its rights effective against the debtor of the receivable, the assignee will simply collect payment, applying the proceeds to reduction of the assignor's obligation. The rationale is that the rights of the assignor and third parties will be protected simply by the normal application of the money received to a reduction of the secured obligation. Consistent with the approach taken by these States, the Guide recommends that no further steps to achieve enforcement need be taken (see recommendation 165).

87. Nonetheless, there may be cases where the assignee may wish to appropriate the entire present value of a receivable that may be spread out in instalments due over several months. It may, therefore, after notifying the debtor of the receivable that it will be collecting the account, sell or transfer the receivable to a third person.

To protect the assignor's rights in such cases, many States provide that the assignee may not keep any excess, a position the Guide adopts not only in relation to such dispositions of receivables, but also in relation to the ordinary collection of receivables (see recommendation 113, subparagraph (b)). Moreover, the assignee must act in a commercially reasonable manner in disposing of the receivable (see recommendation 128).

88. In some cases, the receivable itself will be secured by some other personal or property right (e.g. a personal guarantee by a third party or a security right in movable assets of the debtor of the receivable). Many States provide for an automatic right of the assignee to enforce these other rights should the debtor of the receivable be in default to pay the receivable as it falls due. This is a normal consequence of a security right (the accessory follows the principal) and the Guide adopts a like recommendation concerning guarantees of the third-party obligor's obligation to pay (see recommendation 166). This rule applies to the right to receive the proceeds under an independent undertaking as well (see recommendations 25, subparagraph (b), 48, 104, 124 and 166).

3. Enforcement in the case of an outright transfer of a receivable

89. The Guide applies to outright transfers of receivables as well as security rights in receivables (see recommendation 3). However, in an outright transfer, the assignor has generally transferred all of its rights in the receivable. Thus, the assignor has no continuing right in the receivable and no interest in the realization (usually collection) of the receivable. Accordingly, the present chapter on enforcement applies to the outright transfer of a receivable only when the assignee has some recourse to the assignor for the non-collection of the receivables. That is, it is only where the assignor may ultimately be liable to the assignee that it has an interest in the method of the collection or other disposition of the receivables (see recommendation 164).

90. Recourse to the assignor for the non-collection of receivables that have been the subject of an outright transfer usually arises when the assignor has guaranteed some or all of the payment of the receivables by the debtor of the receivables. Recourse may also arise from other functionally equivalent arrangements, such as when: (a) the assignor agrees to repurchase a receivable sold to the assignee if the debtor of the receivable fails to pay; or (b) the assignor merely agrees to pay any deficiency between the purchase price for the bulk sale of receivables and the actual collections of those receivables.

91. Recourse to the assignor for non-collection as used here refers only to non-collection because of the failure of the debtor of the receivable to pay for credit reasons (e.g. its financial inability to pay). Consequently, the failure of the debtor of the receivable to pay for tangible assets or services because of their poor quality or the failure of the assignor to comply with its specifications for the assets or services would not be considered as non-collection. Where non-payment arises for credit reasons, however, the normal rules for collection of receivables and enforcement of the security would apply (see recommendations 165 and 166).

4. Enforcement of a security right in a negotiable instrument

92. In many States, it is possible to acquire a security right in a negotiable instrument (for the definition of "negotiable instrument", see Introduction, section B, Terminology), whether by taking possession or following other steps to

achieve third-party effectiveness (see recommendations 32 and 37). As a general rule, even where there is a security right in the instrument, States defer to law governing negotiable instruments in determining the rights of persons obligated on the negotiable instrument and other persons claiming rights in the negotiable instrument (see recommendation 121). These rights might include, for example: (a) the right of the person obligated on the negotiable instrument to refuse to pay anyone other than a holder or other person entitled to enforce the instrument under law governing negotiable instruments; and (b) the right of the person obligated on the instrument to raise certain defences to that obligation.

93. Where security is taken in a negotiable instrument, secured creditors will normally have possession of the instrument. Upon default of the grantor, many States permit the secured creditor to collect or otherwise enforce its security right in the instrument. This would include, for example, presenting it for payment, or, if default occurs before maturity, even selling it to a third party and using the proceeds to pay the grantor's obligation. The rationale is that it would compromise the negotiability of the instrument if the secured creditor were obliged to go through the formalities required to exercise either the recourse of sale or taking the instrument in satisfaction of the secured obligation. Consistent with such practices, the Guide does not recommend that any further post-default formalities be imposed on enforcing secured creditors (see recommendation 167).

94. As with receivables, it may be that the negotiable instrument is itself secured by some other personal or property right (e.g. a personal guarantee by a third party or a security right in movable assets of the debtor of the receivable). Many States provide for an automatic right of the secured creditor to enforce these other rights should the person obligated under the negotiable instrument fail to pay upon presentment. The Guide recommends such an approach to enforcement of guarantees relating to the payment of a negotiable instrument (see recommendation 168).

5. Enforcement of a security right in a right to payment of funds credited to a bank account

95. Many States envision the possibility of creating a security right in a right to payment of funds credited to a bank account (for the definition of this term and other relevant terms, see Introduction, section B, Terminology). In a bank account agreement, the bank is usually considered to be the debtor of the depositor and is obliged to pay the depositor a portion of or the whole amount on deposit when requested. As banking law is closely tied to significant commercial practices, the Guide recommends deference to banking law and also provides additional safeguards for banks whose depositors may have granted security rights in their rights to payment of funds credited to a bank account (see recommendations 32, 49, 100, 101, 122 and 123). For example, even if a depositor has concluded a security agreement with a creditor, the depositary bank has: (a) the same rights and obligations in relation to its depositor; (b) the same rights of set-off; (c) no obligation to pay any person other than the person that has control of the account; and (d) no obligation to respond to any requests for information (see recommendations 122 and 123).

96. Many States provide that, if the encumbered asset is a right to payment of funds credited to a bank account, the secured creditor may collect or otherwise enforce its right to payment of the funds after default or even before default if so agreed with the grantor. Enforcement would normally occur by the secured creditor

asking the bank to transfer the funds to its own account, or otherwise to collect the sums credited to the account. The rationale for this rule is that the encumbered asset is the right to receive payment of the funds credited to the account and that it would be inefficient if the secured creditor were required to enforce by taking possession and following the steps applicable to the sale of encumbered assets or by taking them in satisfaction of the secured obligation. Consistent with the objective of enhancing flexibility and efficiency in enforcement, the Guide recommends that creditors enforcing security in a right to payment of funds credited to a bank account may do so by collecting the money in the account (see recommendation 169).

97. Sometimes, States require the secured creditor to obtain a court order prior to enforcement of a security right in a right to payment of funds credited to a bank account. Such a requirement is understandable in situations where the secured creditor may have obtained third-party effectiveness through registration in the general security rights registry. However, where the bank is aware of the security right because it has entered into a control agreement with the secured creditor, requiring a court order would be an unnecessary formality. For this reason, the Guide recommends that, where a control agreement has been entered into, it is not necessary to obtain a court order for the secured creditor to commence enforcement (see recommendation 170). Conversely, where no such agreement has been entered into, the Guide recommends that a court order be required, unless the bank specifically consents to collection by the secured creditor (see recommendation 171).

98. In many cases, the secured creditor will, in fact, be the depositary bank itself. Here, a formal enforcement process involving a specific act of collection and appropriation of the funds to repayment of the secured obligation would be superfluous. Upon default, a depositary bank acting as a secured creditor normally will deploy its right of set-off to apply the funds in the account directly to payment of the secured obligation in default. In keeping with this practice, the Guide recommends that enforcement of the depositary bank's rights of set-off not be affected by any security rights that the bank may have in the right to payment of funds in that account (see recommendations 26 and 122, subparagraph (b)).

6. Enforcement of a security right in a right to receive the proceeds under an independent undertaking

99. Some States permit persons that have the right to demand payment ("to draw") under an independent undertaking to grant security in the right to receive the proceeds of that right (for the definition of this term and other relevant terms, see Introduction, section B, Terminology). The Guide recommends that security rights may be created in the right to receive such proceeds, subject to a series of rules governing the obligations between the guarantor/issuer, confirmer or nominated person and the secured creditor (see recommendations, 27, 48 and 50). As the law and commercial practices governing independent undertakings are quite specialized, the Guide recommends adoption of a number of rules meant to reflect existing law and practice (see recommendations 124-126). So, for example, where the security right is automatically created, no separate act of transfer by the grantor should be necessary for the secured creditor to enforce a security right in a right to proceeds under an independent undertaking.

100. The general practice of States is to permit a secured creditor whose security right is in the right to receive the proceeds under an independent undertaking to

collect or otherwise enforce its right to payment of the proceeds after default or even before default if so agreed with the grantor. However, enforcement does not permit the secured creditor to demand payment from the guarantor/issuer, confirmer or nominated person (see recommendation 27). Rather, enforcement would normally occur when the secured creditor indicates to the guarantor/issuer, confirmer or other nominated person that it is entitled to be paid whatever proceeds are otherwise due to the grantor. The rationale for this approach is that the guarantor/issuer, confirmer or other nominated person cannot be obliged towards anyone other than the beneficiary and only the beneficiary may request payment of the independent undertaking. The Guide follows the practice relating to independent undertakings and recommends that the enforcement of the security right be limited to collecting the proceeds once they have been paid (see recommendation 172).

7. Enforcement of a security right in a negotiable document

101. Many States permit grantors to create a security right in a negotiable document (for the definition of this term and other relevant terms, see Introduction, section B, Terminology). The Guide recommends a similar practice (see recommendations 2, subparagraph (a), and 28). The negotiable document itself represents the tangible assets that are described in it and permits the holder of the document to claim those assets from the issuer of the document. Normally, secured creditors will enforce their security right by presenting the document to the issuer and claiming the assets. Special rules may, however, apply to preserve the rights of certain persons under the law governing negotiable documents and the Guide defers to that law (see recommendation 127).

102. Nonetheless, as between the grantor and the secured creditor, enforcement will occur when the secured creditor presents the document to the issuer. At this point, the secured creditor will be in possession of tangible assets and enforcement of the security right will then be subject to the normal principles recommended for the enforcement of security rights in negotiable documents or tangible assets covered by them (see recommendation 173). Depending on the agreement between the parties, either upon default or prior to default with the grantor's permission, the secured creditor may dispose of the document. This must be done in a commercially reasonable manner and the price obtained for the sale of the document will be applied to satisfaction of the secured obligation.

C. Recommendations

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

A/CN.9/637/Add.5 [Original: English]

**Note by the Secretariat on terminology recommendations of the UNCITRAL draft
Legislative Guide on Secured Transactions, submitted to the Working Group on
Security Interests at its twelfth session**

ADDENDUM

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XI. Acquisition financing

A. General remarks

1. Introduction

(a) The nature of acquisition financing

1. The purchase and sale of tangible assets (for the definition of “tangible assets” see Introduction, section B, Terminology) is a central activity in a modern commercial economy. Almost every business buys or sells this type of asset at some time or another. For some businesses, such transactions (e.g. the acquisition of raw materials and their subsequent manufacture and sale or the purchase of inventory at wholesale for distribution to retailers or for resale at retail) are a central activity. For other businesses, the purchase and sale of tangible assets is not the central activity, but it is nonetheless important to the extent that a business requires an investment in equipment and this equipment may need to be augmented, upgraded or replaced from time to time.

2. However, the acquisition of tangible assets is not just an activity of businesses. Consumers are constantly purchasing tangible assets. These assets range from low-price consumer goods, through mid-range durable assets such as furniture, electronic devices and kitchen equipment, to high-value assets such as automobiles and recreational vehicles.

3. In many cases, the acquisition of tangible assets by businesses or consumers is on a cash basis. In many other cases, however, needed assets are acquired on credit. Whenever a business or consumer acquires tangible assets on credit, and rights in the assets being acquired serve as security for the credit being extended, the credit transaction is a form of secured transaction, which the Guide calls an “acquisition financing transaction”. The right that the seller or creditor retains or obtains in the assets that are supplied to the buyer or grantor may be called, depending on the precise character of the right, either an acquisition security right, or a retention-of-title right, or a financial lease right (for the definitions of “grantor”, “acquisition security right”, “retention-of-title right” and “financial lease right” see Introduction, section B, Terminology).

4. Acquisition financing transactions are among the most important sources of credit for many buyers of tangible assets. In addition, acquisition financing transactions are critical to many sellers, even when their buyers do not otherwise regularly purchase assets on credit. For example, in many States, the sale of automobiles normally involves an acquisition financing transaction. While buyers may seldom engage in such transactions for other purchases, their availability is critical to the business of automobile sellers. In many respects, acquisition financing transactions are identical to ordinary secured transactions as described in previous sections of the Guide. However, in other respects, they have particular features that have led States to provide for special rules in several situations. This chapter considers the ways in which States may achieve an efficient and effective regime to govern all types of acquisition financing transaction.

5. Because of the number and diversity of acquisition financing transactions today, for the purposes of this chapter it is important to state clearly how the Guide

uses this term, as well as various other terms. In several cases these other terms coincide with terms now in use in many States. The Guide makes a conscious choice in this chapter not to generate new, unfamiliar terms. However, the terms used here are meant to have the meanings provided in the definitions, which may well differ from the meanings in any particular State today.

6. The only new term is the generic concept “acquisition financing transaction”. An acquisition financing transaction exists whenever one person may claim a property right in tangible assets to secure another person’s obligation to pay any unpaid portion of the purchase price (or its economic equivalent), whether that property right exists in favour of a seller, a lessor or a lender. A transaction under which a seller retains title (ownership) of the assets sold for such a purpose is also an acquisition financing transaction. Thus, the key features of an acquisition financing transaction are two: (a) the credit is used for the specific purpose of enabling the buyer to acquire a tangible asset; and (b) the rights being claimed or retained relate directly to the asset being acquired.

(b) Diversity of forms of acquisition financing

7. As noted in section B of chapter I (Basic approaches to regulating secured transactions) of the Guide, States have developed a wide variety of legal devices through which providers of credit can ensure repayment of their debtor’s obligation. While only some are classically known as security rights, all serve the economic function of securing the repayment obligation.

8. A similar, if not even greater, diversity of legal devices is typically available to those (often sellers) that finance a buyer’s acquisition of tangible assets. For example, a seller that retains title to the asset being sold until the buyer has paid the purchase price in full (a retention-of-title seller), is extending credit terms to its buyer and is thereby financing the buyer’s acquisition of that asset. The retention-of-title right is just one of several devices available to sellers. A seller may also transfer title to a buyer with a proviso that the buyer’s title will be retroactively extinguished if it fails to pay the agreed purchase price (the sale is under a “resolutive condition”); or, a seller may transfer title to a buyer, but take a security right in the asset being sold.

9. Sellers comprise just one category of financiers that may provide credit to enable a person to acquire a tangible asset. Lenders, too, may provide credit to a buyer for the specific purpose of enabling that buyer to purchase assets from a seller. Because both sellers and lenders may provide credit to enable buyers to acquire tangible assets it is possible for more than one person to be claiming a right in a particular asset under acquisition financing transactions involving that asset.

10. Still another form of acquisition financing transaction may not even involve a contract of sale at all. A lessor that leases an asset to a lessee on terms that are economically equivalent to those of a sale on credit is likewise providing financing that enables the lessee to acquire use and enjoyment of the tangible asset as if it owned that asset, even if title never passes from the lessor to the lessee. As in the case of sellers, there are different ways in which lessors may structure the agreement so as to enable the lessee to acquire the economic equivalent of an ownership right in the leased asset. The Guide calls the right of the lessor in such cases a financial lease right.

11. Finally, a lender that provides credit to a lessee for the purpose of paying all payments as they come due under a lease may, depending on the terms of the credit, be an acquisition secured creditor entitled to claim an acquisition security right in the asset being leased. If the credit being extended actually enables the lessee to conclude the financial lease agreement with the lessor, the lender is financing the lessee's use (and notional acquisition) of that asset.

(c) Outline of the chapter

12. This chapter discusses, in section A.2, the commercial background of contemporary acquisition financing transactions, and in section A.3, the various approaches to acquisition finance that have heretofore been adopted in different legal systems. Section A.4 sets out the key policy choices that confront States enacting legislation to govern the various types of acquisition financing transaction. The remainder of the chapter then reviews how the several components of a secured transactions regime discussed in other chapters of the Guide apply in the specific case of acquisition finance. It considers, in section A.5, the creation of such devices (their effectiveness as between the parties), in section A.6, the effectiveness of such devices as against third parties, in section A.7, priority of rights as against the rights of competing claimants, in section A.8, pre-default rights and obligations of the parties, in section A.9, enforcement, in section A.10, conflicts of laws, in section A.11, transition issues, and in section A.12, issues relating to the treatment of acquisition financing transactions in insolvency. The chapter concludes, in section B, with a series of specific recommendations.

2. Commercial background

(a) General

13. The opening paragraphs of this chapter summarized a number of different ways for a buyer to finance its acquisition of tangible assets, such as raw materials, inventory and equipment. In this section, the commercial background of these various transactions and their actual operation in different States today are considered in greater detail. This discussion is meant to illustrate the broad range of transactions, involving a broad range of credit suppliers, which are being deployed to finance the acquisition of tangible assets, and to show the manner in which many transactions serve that purpose even though they are not denominated as such. The discussion is also meant to reveal that among the several States that use these different transactions there is a great diversity both in their scope and their effect. Finally, by briefly considering the advantages and the drawbacks of each of these traditional transactions as mechanisms, the discussion aims to provide a context for the particular approach to acquisition financing recommended in the Guide.

(b) Unsecured and secured acquisition credit

14. An initial distinction to be drawn when considering the purchase and sale of tangible assets in a commercial setting is the distinction between cash sales and sales on credit. Sometimes buyers have sufficient liquidity that they may purchase equipment, raw materials and inventory on a cash basis. As a rule, however, commercial enterprises will acquire a substantial part of their raw materials, inventory and equipment on credit.

15. When tangible assets are purchased on credit, the buyer often obtains the credit on an unsecured basis. This normally occurs in one of the following two ways. First, a buyer might simply borrow an amount equal to the purchase price from a third party on an unsecured basis. For example, while the sale transaction is itself a cash transaction, it may effectively be financed by a general line of credit from the primary lender of the business. This method is simple, but the buyer's credit rating or reputation might limit availability of such credit or make the cost of such third-party credit prohibitively high.

16. Second, a buyer may agree with a seller to purchase the asset on credit terms that allow the buyer to make payment (perhaps in instalments) after the completion of the sale. Here the seller transfers possession and ownership of the asset to the buyer but is paid the purchase price at a later time, whether in a lump sum or through periodic instalment payments. This method is not really different from third-party finance except that the risk of non-payment is now on the seller rather than on a third-party financier. Many sellers are, however, unwilling to bear such an unsecured risk.

17. As a result, buyers often find that, as a practical matter, it is necessary to provide some form of security in order to acquire tangible assets on credit. The assets subject to the security right could well be other existing assets of the buyer. For example, a business could grant security over its factory or warehouse to secure repayment of a loan to be used to acquire equipment, inventory or raw materials. Typically, however, the most obvious asset in which security may be taken, and frequently the only such asset available to a buyer, is the asset actually being acquired.

18. Security for acquisition credit in the assets being acquired can arise in several different ways. For example, in some States, sellers have special rights arising by operation of law that enable them to cancel the sale and take back the asset sold if the buyer does not pay the purchase price within a certain period after delivery. Similarly, other States give sellers an automatic (non-consensual) right to claim a priority or preference in the distribution of proceeds of a sale (in execution) of the asset they have supplied. Often, however, the security claimed by an acquisition financier does not arise by operation of law, but is the result of an agreement between the seller or lender and the buyer.

19. As a matter of commercial practice, most acquisition credit results from an agreement between the buyer and the credit provider. As noted, these consensual acquisition financing transactions can take many forms and involve many different providers of credit. For example, the buyer may formally grant a security right in the asset to a third-party financier; or the buyer may formally grant such a security right to the seller; or the buyer and seller may agree to some other legal mechanism, which, although not in the form of a security right, is its economic equivalent. Historically, two such other mechanisms, both using ownership of the asset to secure payment, have played a central role in acquisition financing. These mechanisms are: (a) the seller's retention of title to the asset until the purchase price is paid; and (b) the use of a transaction documented as a lease. They are considered in turn, prior to a review of modern acquisition financing mechanisms available to both sellers and lenders.

(c) Retention-of-title and similar transactions

20. A supplier of raw materials, inventory or equipment may wish to meet its customer's need for credit by supplying the asset to the customer under an agreement by which ownership does not pass to the buyer until the purchase price has been paid in full. In many cases the agreement is between the seller and the buyer without any intermediary. In some cases, however, the seller may sell the asset for cash to a finance institution or other lender, which may then sell the asset to the buyer under an agreement that provides for retention (or reservation) of ownership (or title) until full payment of the purchase price.

21. There are many types of agreement through which sellers may reserve ownership of the assets sold until full payment of the purchase price. The retention-of-title mechanism is very common. In this transaction the buyer's right to obtain title is conditional upon it paying the purchase price; until then, the seller is not required to transfer ownership to the buyer. While the buyer usually obtains immediate possession of the asset being purchased, ownership remains vested in the seller.

22. Retention-of-title arrangements are sometimes called "conditional sales". Generally, however, in transactions called conditional sales the sale itself is not conditional (that is, the actual sale agreement is not dependent on the occurrence of some future and uncertain event not related to the sale itself). Rather, under a conditional sale, it is the transfer of ownership to the buyer that is conditional. The seller reserves ownership of the asset sold until the purchase price has been paid in full or the buyer has complied with any other conditions prescribed in the sale agreement.

23. In addition to retention-of-title arrangements, there are a wide variety of other transactions in which a seller uses ownership to secure the unpaid purchase price of an asset it sells. For example, sometimes the reservation of a seller's ownership is structured as a sale with a term, and the transfer occurs only at the end of the stipulated term. In other transactions, possession of the asset is delivered to the purchaser under a "promise of sale" or an "option to purchase". Some States attempt to regulate these latter transactions by providing that a promise of sale accompanied by delivery is equivalent to a sale. Occasionally, a seller will actually transfer ownership to a buyer at the moment of sale, with a proviso that the buyer's title will be retroactively extinguished should it fail to pay the agreed purchase price according to stipulated terms.

24. In each of these cases, the key feature is that the agreement by the seller to postpone full payment (that is, to offer credit) is protected either by delaying the passing of title to the asset to the buyer or, less commonly, by transferring title to the buyer subject to the seller's right to regain title upon failure of the buyer to pay. As a general principle, the idea is that the buyer does not irrevocably acquire ownership of the asset being sold until the purchase price is fully paid.

25. Another form of transaction that has been used to serve the same economic function is a "consignment". The typical consignment structure is as follows. The consignor (the notional seller) retains ownership of tangible assets (typically inventory held for resale), but transfers possession to the consignee that is authorized to sell these assets to a third party. Upon such a sale the consignee is obliged to remit to the consignor an agreed amount. In the case of a true

consignment, the consignee has no absolute obligation to pay the agreed price; its obligation is either to pay the agreed price or to return the assets to the consignor (a right that a true buyer does not have). Thus, it is critical to examine the nature of the consignee's obligation: if it is to pay the price, but with payment deferred until the assets have been sold by the consignee, and the ownership of the assets is retained by the consignor to function as security (like a title-retention transaction), then it fits into the category of an acquisition financing transaction discussed in this chapter. Moreover, this will be the case even if ownership of the consigned assets never formally passes to the consignee because they are deemed to have been transferred directly from the consignor to the third party that bought from the consignee.

26. The most common of the above arrangements is the retention-of-title transaction. In some States, the basic transaction may be varied through various clauses that greatly expand its usefulness as an acquisition financing device. So, for example, the parties may be permitted to agree to an "all-monies" or "current-account" clause. Where such clauses are used, the seller retains ownership of the asset sold until all debts owing from the buyer to the seller have been discharged (and not just those arising from the particular contract of sale in question). This means, for example, that the seller will be able to assert its retained ownership rights in the asset sold against all other potential claimants until the unpaid purchase price for all other assets sold by the seller to that buyer has been paid in full.

27. In addition, in some States parties are permitted to add "products" clauses, in which the seller's ownership is extended to, or the seller is deemed to have a security right in, any products that are manufactured from the asset in which the seller retained ownership. Similarly, some States allow for "proceeds" (for the definition of "proceeds", see Introduction, section B, Terminology) clauses under which sellers may claim ownership or a security right in any proceeds generated by the sale of the assets in which they have retained ownership (for the treatment of proceeds in the case of ordinary security rights, see recommendations 19 and 20), although this is quite rare. In most of these States, however, the seller's transformed security right in the proceeds does not benefit from any special priority.

28. While there are great divergences in the extent to which States permit modification of the basic retention-of-title transaction, many adopt a traditional posture. In these States, the applicable law strictly limits the scope of the seller's retained ownership. The right may be claimed: (a) only upon the tangible asset sold (i.e. neither on proceeds of disposition, nor on replacement assets); (b) only so long as the asset remains in its original condition (i.e. unaltered by the manufacturing process); (c) only to secure the sale price of the particular asset; or (d) only when some combination of these three conditions is met.

29. Given the continued centrality of retention-of-title in many States today, for the purposes of this chapter, the expression "retention-of-title right" will be used generically to refer to the right of a supplier under all types of sales transaction where a buyer does not irrevocably acquire ownership of the asset being sold until the purchase price is fully paid (for the definition of "retention-of-title right", see Introduction, section B, Terminology).

(d) Leases, hire-purchase transactions and financial leases

30. A supplier may also use the concept of a lease to enable its customers to acquire the use of an asset without having immediately to pay its purchase price. There is a wide variety of lease transactions that can be used as acquisition financing mechanisms. For example, a supplier of equipment may simply lease a piece of equipment to a business that takes possession of the equipment and makes monthly rental payments. In this agreement, the supplier necessarily retains ownership of the equipment (as lessor) and the lessee merely pays the rent as it falls due. While it is conceivable that such a lease arrangement could involve raw materials or inventory, parties will typically deploy these types of transaction to enable businesses to acquire the use of equipment (e.g. machinery, vehicles, computers, photocopiers, display racks, office furniture and hardware).

31. In many cases, the lease agreement is structured to achieve the functional equivalent of a title-retention sale. For example, the term of the lease may be for the useful life of equipment being sold so that at the end of the lease the lessee has enjoyed the equivalent benefit to having owned the equipment (whether or not ownership ever passes to the lessee and whether or not the lessee has an obligation to purchase the equipment at the end of the lease). Alternatively, the lease period could be for less than the useful life of the equipment but, at the end of the lease period, the lessee has the option to purchase the equipment at a nominal price or to extend the term for the balance of the useful life. In some States, this type of lease arrangement can only exist if the lessee is not obliged or even entitled to acquire the leased asset. In these States, it is the fact that ownership is never transferred that distinguishes a lease from a title-retention sale, but this transfer is not relevant to whether the transaction should be characterized as an acquisition financing transaction. Whenever the transaction is denominated as a lease, what really matters is whether the lessee is acquiring the use of the asset for at least most of its useful life in exchange for notional rental payments that represent the economic equivalent of its price under an instalment sale.

32. In a number of States, a similar result to a retention-of-title sale is achieved through devices called “hire-purchase transactions”. However, not all States use the expression to identify the same arrangement. For example, in some States, the hire-purchase arrangement commences with the lessee (hire-purchaser) selecting the equipment from the supplier (hire-seller) of the equipment. The lessee would then apply to a leasing company (usually a financial institution or an affiliate of one) to purchase the equipment from the supplier for cash and to lease it to the lessee (hire-purchaser). As with an ordinary financial lease, very often the lease comprises the useful life of the equipment and, at the end of the lease period, the lessee automatically acquires ownership or has the option to purchase the equipment at the end of the lease period for a nominal sum. In other States, the expression is used to cover transactions where a business leases the asset directly from the manufacturer and either automatically acquires ownership or has the option to purchase the equipment at the end of the lease period. For the purposes of this Guide, the expression is meant to cover any transaction that starts out as a lease arrangement, but contemplates that the lessee will acquire ownership of the asset at the end of the lease period.

33. Yet another acquisition financing transaction that takes the form of a lease is what many States label a “financial lease” or a “finance lease”. In these States,

financial leases are granted special tax advantages that have the economic effect of reducing the cost to the lessee. Whether the financial lease agreement is a two-party arrangement between lessor and lessee or a three-party arrangement, the transaction takes the form of a lease. Nonetheless, in each case, the economic reality is that the lessee is paying the notional purchase price for the equipment in instalments, while the lessor remains the owner until full payment is made. It is important to note, however, that the economic effects of such a transaction as an acquisition financing mechanism are not necessarily related to how a financial lease may be characterized for tax purposes. Consequently, a transaction may be a financing lease for secured transactions purposes although not one for tax purposes, or vice versa.

34. States that make general use of transactions in the form of leases as acquisition financing devices not only use different terms to describe these transactions, they also attach different consequences to their deployment. For example, in some States, the lessee is able to sell the leased asset and a good faith purchaser will be able to assert its rights against the lessor. In a few of these States, however, the lessor may be able to claim a right in the proceeds of the sale. In other States, the lessor may always be able to claim its right against an ostensible purchaser. Again, in some States, a lessor is able to reclaim the asset without the need for a judicial order if the lessee is in default. In other States, the lessor must first seek formal termination of the contract, and reclaim possession judicially. Finally, in some States, these transactions are strictly regulated by mandatory rules, while in others the specific leasing arrangements are tailored to the lessee's unique cash-flow requirements, the tax regime in a State and other needs of the lessor and lessee.

35. The above discussion suggests a great diversity in these lease transactions. Depending on the nature of the equipment at issue, lease periods may range from a few months to several years and items leased may range from high-value equipment, such as aircraft, to lower-value equipment, such as computers. In all cases, however, and whatever may be the definition given to a financial lease for tax or accounting purposes in any State, for the purposes of this chapter the expression "financial lease right" will be used generically to refer to all transactions that take the form of a lease but where the functional equivalent of ownership will be enjoyed by the lessee, regardless of whether formal title to the asset is ever transferred to the lessee (for the definition of "financial lease right", see Introduction, section B, Terminology).

(e) Security rights of sellers

36. In many States today, several other legal devices are available to secure the performance of a buyer's payment obligations. As noted, in some cases, rights arise by operation of law. These non-consensual rights of sellers typically presuppose that ownership of the asset being sold has passed to the buyer. For example, in some States the seller of tangible assets is given a high-ranking "privilege" or a "preferential claim" on the money generated by a sale in execution of these assets. Whether the sale in execution is brought by the seller that has itself obtained a judgement against the buyer, by another judgement creditor of the buyer or by a secured creditor exercising a security right against the assets, the seller may claim its statutory priority. What is more, when it exists, this statutory preferential right (often called a vendor's privilege) is usually given a priority that is superior even to that of consensual secured creditors.

37. In some States, a seller also has a right to refuse to deliver tangible assets to a buyer that is not ready to pay the price at delivery. This right to refuse delivery usually also includes a right to interrupt the transport of assets by a carrier (the right of stoppage in transit). Occasionally, this right is projected forward as a reclamation right for a short period (e.g. 30 days) after delivery of the assets. None of these rights is particularly effective as a means for financing the acquisition of assets, however, since they invariably presuppose that the sale is made for cash and not on credit.

38. In addition to these rights attached to the contract of sale, traditionally sellers were also entitled to take a regular security right in the assets they sold. In many States, however, this was not an effective mechanism given the absence of a non-possessory security device. For example, a seller that transferred ownership of an asset title to a buyer would then have to keep or retake possession of that asset as a pledge. By contrast, other States have long permitted sellers to take non-possessory security, often in the form of a so called “chattel mortgage”. More recently a number of States that previously did not allow the “hypothecation of movable assets” have also modified their law to permit a seller to contract for a non-possessory security right in the assets it sells. This type of seller’s security right is usually available only in States that have also decided to permit lenders to take non-possessory security rights over tangible assets.

39. The development of non-possessory security rights in favour of a seller has usually been accompanied by another development. Sellers that take security are able, if they follow the appropriate procedure, to assert a priority over all other security rights in the asset being sold that are granted by the purchaser. In some States this special seller’s security right is called a “vendor’s hypothec”; in others it is called a “supplier’s lien” or “supplier’s charge”; in others it is called a “purchase-money security interest”. The name is of little consequence. What matters is that: (a) the seller’s non-possessory security right is identical in form to the non-possessory security right that may be taken by an ordinary lender; and (b) it is vested with certain special advantages. The seller that takes such a security right is usually able to claim a preferred priority position that allows it to outrank any other secured creditor that is asserting rights in the asset granted by the buyer.

(f) Lender acquisition financing

40. In most modern economies, lenders provide a substantial segment of the acquisition finance market. Nonetheless, many States historically placed significant limitations on a lender’s capacity to provide acquisition financing. For example, it was often not possible for buyers to grant non-possessory security over assets they were in course of acquiring. Today, several States that permit lenders to take non-possessory security still do not also permit them to obtain a special priority when they provide acquisition credit. That is, even where the money advanced to the buyer was specifically intended to be used to purchase assets and was in fact used for that purpose, the lender that took security in those assets was considered to be an ordinary secured creditor subject to the ordinary priority rules governing security rights. As a result, in these States, a lender that provides acquisition financing for a particular asset will rank lower than a pre-existing secured lender with a security right in a buyer’s after-acquired assets of the type being purchased.

41. The only mechanism by which lenders could achieve the same preferred status as sellers and lessors was to acquire their rights. So, for example, where sellers retained ownership to secure the buyer's payment obligation, sometimes lenders would directly pay the purchase price to the seller and take an assignment of the seller's right to payment under the sale agreement, along with the seller's retention-of-title right. Similarly, in cases where the law enabled sellers to take a consensual security right with a special priority status in the asset being sold, the lender could purchase the seller's security right. Finally, in cases involving financial leases, the lender would sometimes purchase the lease contract (embracing the financial lease right) from the lessor. The particular form of transaction known in some countries as hire-purchase is a modern adaptation of this long-standing technique. While these lender's rights derived from sellers permit lenders to enter the acquisition finance market, they do not promote open competition among credit suppliers since: (a) either the consent of the seller will be required (often at a cost to the lender), or the lender will have to engage in multiple transactions (involving, for example, the purchase of and subrogation into the seller's rights) to achieve the desired outcome; and (b) the lender will be required to become the owner of the asset being acquired (a status it may not wish to assume).

42. Today, in order to promote competition for acquisition credit, some States permit lenders that provide acquisition financing to buyers of tangible assets to obtain, in their own name, a preferential security right in those assets. In other words, in these States it is now possible for lenders to accede directly to a priority status that was previously available to them only by purchasing the preferential right granted by a buyer to a seller. Not all lenders that provide money to a business that might ultimately be used to purchase tangible assets will be able to claim an acquisition security right. To be able to do so, the lender: (a) must advance the credit to enable the purchaser to acquire the assets; (b) the credit must actually be used for that purpose; and (c) the right can only be claimed in the assets thereby acquired.

43. Even though this special type of lender acquisition security right may be found in a number of States, the idea that a lender might be able directly to claim a preferential acquisition security right is not broadly accepted. Indeed, most States that permit sellers to secure the purchase price of the assets being sold through a distinct retention-of-title right do not permit lenders to claim preferential acquisition security rights. In these States, lenders as well as sellers may take non-possessory security, but typically, only sellers are permitted to claim a preferential acquisition security right, which they may do as an alternative to retaining ownership.

3. Approaches to financing the acquisition of tangible assets

(a) General

44. In the past, States have taken a wide variety of approaches to regulating acquisition financing transactions. As noted, however, protecting the rights of sellers was typically conceived as the central objective. Moreover, until recently, in many States it was not possible for a buyer to grant a non-possessory security right in tangible assets, even to a seller. For these two reasons, the retention-of-title technique developed as an everyday practice in civil law, common law and other systems. Sometimes States enacted legislation to acknowledge and regulate this acquisition financing technique. Most often, however, they failed to do so, with the

result that the contemporary law of acquisition finance in these States emerged from contractual practices that were later explicitly recognized and further elaborated by courts.

45. In order to appreciate the policy choices relating to acquisition financing now open to States, it is helpful to briefly consider three of the common approaches that have been taken to acquisition financing: (a) approaches that favour seller-based acquisition credit; (b) approaches that promote both seller- and lender-based acquisition credit as complementary but distinct mechanisms; and (c) approaches based on a fully integrated approach to acquisition finance that does not conceptually distinguish between sellers and lenders.

(b) Approaches favouring seller-based acquisition financing

46. The development of the law of acquisition finance in many States focused on the protection of sellers. In no State did the legislature and courts set out to prevent financial institutions from providing acquisition financing. However, because this field was conceived as an adjunct to the law of sale, in these States retention-of-title and economically equivalent devices available uniquely to sellers, as opposed to financial institutions, were the main, if not exclusive, acquisition-financing devices that enabled buyers to obtain possession of the assets being purchased.

47. As an element of sales law that specifically touches the property aspects of the transaction, the character and effects of retention-of-title mechanisms vary widely from State to State. Many of these differences are products of history and the specific contractual practices that were adopted in response to (and frequently to overcome limitations imposed by) the legal rules in place in individual States. Thus, the law in this field has tended to develop in a haphazard way with novel contracts and additional terms to well-known types of agreement being invented piecemeal, as the need arose, to serve as proxies for a fully developed regime to govern acquisition financing transactions. As a result, the everyday contractual practices sometimes are not coherent with the legislative policy reflected by the current law in a State, and do not reflect the kinds of practices that business would adopt if the legal regime were designed to promote efficient secured credit.

48. The approach that focuses on sellers as the principal source of acquisition finance is occasionally based on a policy decision to protect small- and medium-sized suppliers of tangible assets against large financial institutions. The approach acknowledges the importance of these manufacturers and distributors for the domestic economy and the dominant position of large institutions in credit markets. The policy decision to afford special treatment for sellers is often argued to rest on a number of assumptions. One is that suppliers have an interest in providing credit at low rates to increase the volume of their sales. Another is that the cost of such credit is affordable because many suppliers do not charge interest prior to default. A third is that, because there will usually be several suppliers seeking to sell tangible assets to any given buyer, competitive prices will be offered to buyers.

49. A State considering secured transactions law reform needs to evaluate these assumptions carefully. While some may be justified, others may not. For example, the fact that a supplier sells assets to a buyer under a retention-of-title arrangement does not necessarily mean that the seller's credit terms come at no cost to the buyer. The supplier itself has a cost of obtaining funds in order to extend these credit

terms. In cases where interest is not charged to the buyer until it fails to pay the purchase price for the goods in a timely manner, presumably the seller's cost of funds will be embedded in the price of the assets being sold and passed on to the buyer.

50. Even if a State interested in promoting the manufacture and supply of tangible assets wishes to encourage sellers to act as suppliers of credit, it need not, and should not, do so to such an extent that other parties are excluded from offering competitive acquisition financing. In the same way that competition among sellers normally reduces prices for buyers, competition among suppliers of credit normally reduces the cost of credit to borrowers and increases its availability. Fostering competition among all suppliers of credit will not only result in credit being available to the buyer at the most affordable rates, but is also likely to open up new sources of credit for buyers. This, in turn, will increase their capacity to purchase tangible assets without the need for sellers themselves to provide financing to all their potential buyers.

51. Legal barriers that prevent financiers other than sellers and lessors from directly extending acquisition credit to buyers, or that require these other financiers to extend credit only through the seller or lessor (by taking an assignment of the seller's retention-of-title right or the lessor's financial lease right), can be inefficient in other respects as well. Most importantly, treating acquisition financing simply as a matter of protecting the property rights of sellers and lessors can actually reduce the scope of the rights otherwise claimable by those sellers and lessors. Many modern secured transactions regimes offer secured creditors a number of rights that often have not, or not always, been available to sellers that use retention of title to secure their claims. These include, for example, an automatic right to claim a security right: (a) in any products that are manufactured from the assets in which a security right is granted; (b) in any proceeds generated by the sale of the encumbered assets; or (c) to use the security right to secure all debts that may be owing from the buyer to the seller.

(c) Approaches promoting both seller- and lender-based acquisition financing

52. In part to expand the range of potential providers of acquisition financing to buyers, and in part to enable sellers to avail themselves of a full panoply of rights previously available to lenders that took security rights, many States today have redesigned their acquisition finance regime so as to promote both seller- and lender-based acquisition financing. Different approaches have been taken to achieve this outcome.

53. In some States that recognize special acquisition rights for sellers based on a reservation of ownership, retention-of-title sellers are now able to expand their rights by contract through the insertion of additional clauses into the agreement of sale. For example, some States permit retention-of-title sellers to insert a clause in the sale contract extending the seller's right into assets manufactured from the asset initially sold, or a clause (often referred to as an "all sums clause") allowing the retention of title to specific goods to stand as security for all obligations owed to the seller by the buyer. In rare cases, a State will also permit a retention-of-title seller to insert a clause in the sale contract extending the seller's right to receivables or other proceeds arising from the sale of the goods. Nonetheless, in most States that maintain special sellers' rights based on a reservation of ownership, only the simple

retention-of-title is treated as a title device, while these other, more complex retention-of-title arrangements are either not recognized or are treated as giving rise to security rights or fiduciary or other rights. It also bears notice that some States have also enhanced the rights of buyers under a retention-of-title arrangement, by recognizing a buyer's expectancy right in assets being acquired under a retention-of-title arrangement and permitting the buyer to grant a lower-ranking security right in the assets (or, in the case of goods to be acquired in the future, the expectancy of receiving such goods) in favour of another creditor.

54. A few States have reformed their secured transactions legislation to enable sellers to take preferential acquisition security rights, but still permit retention of title, financial leases and similar devices to co-exist as separate acquisition financing transactions. In these States, the various devices by which ownership is used to secure a buyer's obligation are, however, usually regulated by substantially the same set of rules as those applicable to a seller's acquisition security rights. Still other States maintain traditional sellers' acquisition financing rights alongside sellers' acquisition security rights, but also allow lenders to claim security rights in the assets being sold. To avoid the risk of imperfect coordination among various types of acquisition finance, these States often go further and require sellers to register a notice of a retention-of-title right in the security rights registry, and to follow the same procedures for enforcement that would apply to enforcement of a security right.

55. This last approach is based on a policy decision to provide, as far as possible, for the equal treatment of all transactions that are deployed to finance the acquisition of tangible assets. Attempting to create more or less equal opportunities for all credit providers, it is assumed, will enhance competition among them, thereby increasing the amount of credit available and reducing its cost to the benefit of both sellers and buyers. These types of modernized regime thus integrate sellers' and lessors' rights into the secured transactions regime, thereby facilitating financing on the security of the buyer's or lessee's expectancy, but at the same time, prevent other financiers to compete directly for a first-ranking acquisition financing right in the assets being purchased. In other words, while these States have adopted regimes that go a long way to achieving equal opportunities for the provision of acquisition credit, there is still a preferred priority status that is afforded to sellers over lenders that provide acquisition finance.

(d) Approaches based on the fully integrated "purchase-money" security right concept

56. Some States have taken an additional step. Not only have they adopted an approach that permits and promotes both seller and lender acquisition credit, but they have also enacted regimes that treat all providers of acquisition financing equally. In these States, lenders can acquire the same preferential priority as sellers that take security rights in the assets they sell. For regulatory purposes, the various acquisition financing rights of owners (retention-of-title, financial leases and similar devices) are: (a) fully integrated into a single, functional security right; and (b) treated identically to the standard acquisition security rights available to sellers and lenders. In many States that have adopted this approach, these various acquisition security rights are all characterized as "purchase-money" security rights

(for the definitions of “security right” and “acquisition security right”, see Introduction, section B, Terminology).

57. Where the “purchase-money” security rights approach has been adopted, two important principles govern its application. The first is that a purchase-money security right, which in the Guide is referred to as an “acquisition security right”, is a generic concept. That is, it is applicable to any transaction by which a financier provides credit to enable a buyer to purchase tangible assets and holds a right in the assets being purchased to secure repayment of that credit. The second is that a purchase-money security right is a species of security right. That is, except where the particular circumstances of acquisition financing require a special rule applicable only to such rights, all the rules applicable to security rights generally also apply to acquisition security rights.

58. The following are the main features of the acquisition security rights regime (using the terminology of the Guide) in States that have adopted the fully integrated, purchase-money security right approach:

(a) The right is available not only to suppliers of tangible assets, but also to other providers of acquisition financing, including lenders and financial lessors;

(b) The acquisition secured creditor is given, for secured transactions purposes, a security right, regardless of whether the creditor retains title to the assets being acquired;

(c) The buyer may offer a lower-ranking security right in the same assets to other creditors (and is thus able to utilize the full value of its rights in assets being acquired to obtain additional credit);

(d) Whether the agreement creating the acquisition security right is denominated as a security right, or is a retention-of-title right or a financial lease right, the acquisition secured creditor, like other secured creditors, normally has to register a notice of its security right in the general security rights registry;

(e) Once a notice of the security right is registered in the general security rights registry, the security right is effective against third parties;

(f) If the notice is registered within a short period of time after delivery of the assets to the buyer, the acquisition security right will normally have priority over competing claimants, including a creditor with a pre-existing security right in future (or after-acquired) assets of the buyer; and

(g) The acquisition secured creditor that is a seller or a financial lessor may enforce its rights, within or outside insolvency proceedings, in the same way as any other secured creditor and does not have, in addition, any title-based enforcement rights.

59. Over the past few decades, an increasing number of States have adopted this fully integrated approach to acquisition financing. This trend may also be seen at the international level. For example, the International Institute for the Unification of Private Law (Unidroit) Convention on International Interests in Mobile Equipment governs the effectiveness against third parties of retention-of-title and financial leases with separate but substantively similar rules to those regulating security rights. Accordingly, it extends the international registry contemplated by the Convention beyond security rights to retention-of-title and to financial leasing

arrangements. Moreover, under the United Nations Assignment Convention¹ the same rules apply to (a) security assignments; (b) assignments for security purposes; and (c) outright assignments (see article 2, subparagraph (a)), thus avoiding drawing a distinction between security rights and title-based devices. Indeed, article 22 of the Convention, which expressly covers various priority conflicts, includes a conflict between an assignee of receivables and a creditor of the assignor whose retention-of-title rights in tangible assets extend to the receivables from the sale of those assets. Finally, the same approach to acquisition financing is followed in the European Bank for Reconstruction and Development Model Law on Secured Transactions, the Organization of American States Model Inter-American Law on Secured Transactions and the Asian Development Bank's Guide to Movable Registries.

4. Key policy choices

(a) General

60. The Guide (see chapter I, section B, Basic approaches to regulating secured transactions) reviews the basic approaches to security that might be adopted by a State seeking to reform its secured transactions law. A key question addressed in that chapter is how to treat transactions that fulfil the economic function of a security device but are effectuated by utilizing title to an asset to secure the full payment of the financier's claim. This question arises in both non-insolvency and insolvency contexts.

61. Many States today continue to maintain a formal diversity of financing devices in all situations. That is, they recognize both security devices and devices such as fiduciary transfers of title and mortgages and sales with a right of redemption where a transfer of ownership of a borrower's assets is made to secure performance of an obligation. Other States maintain this formal diversity in non-insolvency situations, but under their insolvency regime characterize as security devices transactions where the right of ownership (or title) is used to secure payment of a creditor's claim. In these latter States, all transactions that fulfil the economic role of security are treated as functionally equivalent for insolvency purposes.

62. Other States have extended this "functional equivalence" approach to non-insolvency as well as insolvency contexts. The regimes in these States recognize the distinctive character of these various transactions involving title: sellers are still permitted to engage in retention-of-title or resolutive sale transactions, and lenders are still permitted to engage in secured transactions or sale transactions with a right of redemption. However, to ensure a proper coordination among these various transactions, and also to ensure, as far as possible, their equal treatment, these States subject all these transactions, however denominated, to a framework of rules that produces functionally equivalent outcomes.

63. Finally, some States carry this functional logic to its conclusion and adopt what might be called an "integrated" (or "unitary") approach. Their secured transactions regime characterizes as security all the various transactions fulfilling the economic function of security, regardless of their form, and explicitly denominates them as "security rights" (for the definition of "security right",

¹ United Nations publication, Sales No. E.04.V.14.

see Introduction, section B, Terminology). That is, in these States, the regime does not simply maintain a diversity of mechanisms that are treated as “functionally equivalent”. The regime recharacterizes all these mechanisms as security rights as long as they perform the economic function of a security right.

64. The Guide recommends that States adopt this last approach with respect to non-acquisition secured transactions. All transactions where rights in the grantor’s assets, including ownership, are used to secure an ordinary repayment obligation by a borrower to a supplier of credit should be treated as security devices, and identified as such, in both insolvency and non-insolvency contexts (see recommendations 11 and 12). The Guide calls this the “integrated and functional” approach. As explained earlier (see paras. [...] above), there are three main advantages of such an approach: (a) it more obviously promotes competition among credit providers based on price and thus is more likely to increase the availability of credit at lower cost; (b) it better enables legislative policy decisions to be made on grounds of comparative efficiency; and (c) because all transactions creating security rights are treated the same, the regime is easier to enact and apply.

65. When the obligation being secured is the payment of the purchase price of a tangible asset (that is, where an acquisition financing transaction is involved), a conceptually more complex issue is presented, since the parties involved are not all lenders. They are also sellers. In deciding whether to adopt the “integrated and functional” approach, therefore, States will have to determine whether: (a) the logic of secured transactions should override the logic of the law of sale and lease (or more particularly the logic of the law of ownership) when sellers and lessors use these transactions to secure the payment of the purchase price (or its economic equivalent) of tangible assets; or (b) the logic of sale and lease should override the logic of secured transactions as the primary organizing principle in these cases. In order to decide these issues, States must, first of all, consider whether the approach of providing functionally equivalent outcomes should be adopted as the most efficient way to reach the goal of substantial equality among acquisition financiers; and secondly, if so, States must consider whether the integrated approach should be adopted as the most efficient way to produce a framework of rules that achieves functional equivalence of outcomes.

(b) Functional equivalence: a generic concept of acquisition financing

66. As noted above (see paras. [...]), while closely linked, the principles of functionality and integration are independent. That discussion also notes that equal opportunity to provide credit is one of the primary objectives that States should seek to achieve when reforming their law of secured transactions generally.

67. There are good reasons of economic policy why States might wish to adopt the functionality principle in relation to acquisition financing. In market economies, creating equal opportunities for all credit providers will enhance competition among them, thereby increasing the amount of credit available and reducing its cost. There is no overriding reason of economic principle why the manufacturer or distributor of tangible assets should have a monopoly on providing credit to purchasers. Once it is accepted that financiers should be able to compete to offer buyers access to acquisition credit, the legal regime under which they do so should not create incentives for one or another sub-group of financiers. The most efficient way to ensure that competition for the provision of credit is based solely on the terms and

conditions offered by the financier is to establish legal rules that treat all of them in a way that produces functionally equivalent outcomes.

68. It follows that buyers should be permitted to seek out the best deal possible to satisfy their acquisition credit needs. They should have equal opportunity to negotiate, with any potential financier, the terms of the loan, the conditions of repayment, the interest to be charged, the events that would constitute a default and the scope of the security they provide. If the legal regime permits some financiers to obtain better security rights than others, this equality of opportunity to negotiate is compromised. In other words, from an economic perspective, there is nothing unique about acquisition financing that would induce a State to take an approach to credit competition different from that it adopts in relation to ordinary non-acquisition financing.

69. There are also reasons relating to the design of legal institutions why a State might wish to adopt the approach that aims at producing functionally equivalent outcomes. As noted above (see paras. 36-39), States have traditionally organized credit for buyers of tangible assets by providing specific entitlements for sellers (possibly on the assumption that sellers would provide most purchase-credit and most sales would be one-off transactions relating to individual items). Under such an assumption, the primary concern was simply to ensure that, if the buyer did not pay the purchase price, the seller could recover the sold asset quickly, efficiently and free of any third-party rights. That is, credit was simply an adjunct to the sale, and the seller's primary interest was to receive value for the asset provided to the buyer. Two developments over the past several decades have required States to rethink this position.

70. First, as economies expanded, the need for acquisition credit grew and sellers found that they often could not meet all the credit needs of their buyers. Especially where manufacturers, wholesalers and retailers were purchasing large quantities of raw material and inventory, it became increasingly common for banks, finance companies and other lenders to extend credit to buyers for the express purpose of enabling them to acquire these raw materials and inventory. Second, the types of equipment needed for manufacturing and distribution became increasingly sophisticated and expensive. Suppliers were frequently unable to provide the necessary financing to their prospective buyers. Moreover, often for tax reasons, buyers discovered that it was sometimes more economically advantageous to acquire needed equipment by a transaction documented as a lease rather than a purchase. Frequently, these lease transactions were structured as the economic equivalent of a sale upon credit.

71. In both of these cases, acquisition financing was being provided to a buyer (or notional buyer) by a person other than the direct seller of the assets. States were then confronted with having to decide whether continued reference to the seller's rights as the paradigmatic acquisition finance transaction was justifiable. The main reasons for concern lay in the fact that: (a) sellers were traditionally able to get a top-ranking secured right in the assets based on their ownership, but other acquisition financiers such as lenders typically were not; and (b) when the transaction was structured as a lease rather than a sale in which the seller transferred title to the buyer against a right to have the sale set aside for non-payment of the purchase price, it was generally not possible for the lessee to deploy the leased asset as collateral to secure other credit. These concerns led States to consider whether a

generic concept of an acquisition financing transaction might be a better way to organize this branch of secured transactions law.

72. Many States concluded that, even when they decided that sellers should continue to be able to protect their rights by retaining ownership of the assets sold until full payment by the buyer, the legal regime would be less uncertain and would generate less litigation if it did not draw purely formal distinctions between the rights available to different suppliers of acquisition credit. This led these States to simplify the design of the regime by adopting the approach that produces functionally equivalent outcomes: all transactions being deployed to finance the acquisition of tangible assets would be treated in essentially the same way regardless of their form and regardless of the legal status of the creditor (as seller, lessor or lender).

73. Consistent with the recommendation that States adopt the functionally-equivalent-outcome approach to non-acquisition secured transactions, in this chapter the Guide recommends that States adopt the functionally-equivalent-outcome approach in respect of all acquisition financing transactions, however denominated (see the statements of purpose in chapter XI, options A and B). That is, the Guide recommends that States enact regimes that achieve functionally equivalent outcomes, regardless of whether they also decide to adopt the fully integrated approach (see recommendation 174 for the unitary approach and recommendation 185 for the non-unitary approach).

(c) Unitary and non-unitary approaches to functional equivalence

74. The second main policy choice that confronts States concerns the manner in which they design legislation to achieve functionally equivalent outcomes. Once again, the main objective is to ensure that, in so far as possible, the legal regime that brings about this functional equivalence is crafted in a manner that facilitates the broadest extension of credit at the lowest price. This type of efficiency in a legal regime can be achieved in one of two ways.

75. First, States may choose to collapse distinctions between various forms of acquisition financing transactions and adopt a single characterization of these devices. This is the policy that the Guide recommends for security rights generally. The method for achieving functionally equivalent outcomes is referred to as the “integrated” approach. Given the alternatives outlined in this chapter, the integrated approach will be characterized as the unitary approach to acquisition financing. All acquisition financing transactions under the unitary approach will give rise to “acquisition security rights” and all financiers will be considered as “acquisition secured creditors” (for the definitions of “acquisition security right” and “acquisition secured creditors”, see Introduction, section B, Terminology).

76. Alternatively, States may choose to retain the form of existing acquisition financing transactions and the characterization that parties give to their agreement (e.g. as sale, lease or loan), subject to the court declaring that characterization to be a sham. In doing so, however, States will nonetheless be required to adjust and streamline their technical rules for each transaction so as to achieve functional equivalence across the whole regime. The Guide refers to this method for regulating acquisition credit as the “non-unitary” approach. Acquisition financing transactions under the non-unitary approach will give rise either to “retention-of-title rights” and

“financial lease rights” where a title device is deployed, or to “acquisition security rights” in favour of acquisition secured creditors where a security right (whether in favour of a lender or a seller that transfers title to a buyer) is created (for the definitions of the terms mentioned in this paragraph, see Introduction, section B, Terminology).

77. Depending on law other than secured transactions law, the decision about which of these approaches to adopt could have significant consequences. For example, it might affect the rights of third parties both in and outside insolvency proceedings (the issues relating to insolvency are discussed in section A.12 below and in chapter XIV (The impact of insolvency on a security right)). In addition, having decided to adopt one or the other of these approaches, States will also have to decide exactly how to design the particular rules by which all aspects of acquisition financing transactions will be governed, and integrate them into the general law of sale and lease.

78. Three main consequences flow from a States’ decision to adopt the unitary approach. First, all acquisition financing devices, regardless of their form, will be considered as security devices and subjected to the same rules that govern non-acquisition security rights. Second, a creditor’s right in tangible assets under a retention-of-title sale, sale under resolutive condition, hire-purchase agreement, financial lease or similar transaction will be considered to be an acquisition security right and be regulated by the same rules that would govern an acquisition security right granted to a lender. Third, the buyer in such cases will be considered to have acquired ownership of the asset, regardless of whether the seller or lessor purports to retain title by contract.

79. States may take one of two paths to enacting the unitary approach in cases where sellers use retention of title or a financial lease. They may provide that the buyer becomes the owner for all purposes, with the result that States would explicitly have to amend other legislation (such as taxation statutes) if they desired that sellers in such transactions would be taxed as owners. Alternatively, they might provide that buyers become owners only for the purposes of secured transactions law and its related fields (debtor-creditor law and insolvency law in particular). It is important to note, however, that coherence of the regime requires States to take the same path in relation to acquisition financing transactions that they take in relation to non-acquisition financing transactions.

80. As the Guide adopts a unitary approach to non-acquisition financing, traditional lender transactions such as sales with a right of redemption, sales with a leaseback and fiduciary transfers of title are all considered to be ordinary security rights. Only in relation to seller transactions (and “seller-like” transactions such as financial leases) does the Guide contemplate the possibility of a non-unitary approach. That said, even when States adopt a non-unitary approach to acquisition financing transactions, they should design the regime to reflect the functional equivalence principle (see recommendation 185). For example, the regime should treat all the following suppliers of acquisition credit in a functionally equivalent manner: sellers that retain title; sellers that do not retain title but retain a right to cancel the sale; sellers that do not retain title but take a regular acquisition security right in the assets sold; lessors that retain title; and lenders that take a regular acquisition security right in the asset sold or leased.

81. In principle, States that adopt the non-unitary approach could achieve functional equivalence between the rights of sellers that retain title and financial lessor, on the one hand, and the rights of acquisition secured creditors, on the other, in one of two ways. They could: (a) model the rights accorded to retention-of-title and similar claimants on those given to acquisition secured creditors that are not sellers or lessors; or (b) they could model the rights of these other acquisition secured creditors on the rights already available to retention-of-title creditors. In the former case, all acquisition financiers would be treated the same (i.e. as acquisition secured creditors), but acquisition financiers that retain ownership would have slightly different rights from ordinary owners. In the latter case, all acquisition financiers and acquisition secured creditors would be treated the same (i.e. as owners) but acquisition secured creditors and non-acquisition secured creditors would be subject to slightly different rules. While formally these may appear to be equally viable options, in view of the overall objective to enable parties to obtain secured credit in a simple and efficient manner, there are several reasons why the former approach to achieving functional equivalence in a non-unitary regime should be preferred.

82. One may begin with the objective being sought. The question is what approach is the most likely to achieve the most transparent and lowest cost credit, regardless of the source of the credit. First, it would be quite complicated to design a set of rules that would treat lenders as owners (especially since lenders normally would have no expertise in selling or maintaining the assets they are financing). Second, even though these lenders would be characterized as owners, their ownership would not be identical to ordinary ownership since their enforcement rights would be adjusted to protect the rights of certain third parties that may have taken security in the buyer's expectancy right. Third, it would be quite complicated to design a set of rules that distinguish between the accessory rights afforded to two classes of lenders, namely ordinary secured lenders and acquisition secured lenders. Fourth, it is much simpler to model the rights and obligations of a seller that benefits from an acquisition financing right (for example, in relation to the creation, effectiveness against third parties, priority over competing claimants and enforcement) on those of a seller or lender that benefits from an acquisition security right (an acquisition secured creditor). The reason is that this approach would enhance the overall coherence of the secured transactions regime, while enabling States to make adjustments necessary to maintain the coherence of their regime of ownership as reflected in the law of sale and lease. For these reasons, the Guide recommends that States choosing to adopt a non-unitary approach to acquisition financing transactions should seek to achieve functional equivalence by modelling retention-of-title rights and financial lease rights on acquisition security rights, rather than the reverse (see recommendation 185).

83. The Guide recommends that States adopt the unitary approach to achieving functional equivalence of acquisition finance to non-acquisition secured transactions. Given this general orientation, the Guide suggests that, to the extent that they have the opportunity to do so, States should also adopt the unitary approach to achieving functional equivalence among all acquisition financing mechanisms. Notwithstanding this suggestion, however, the Guide acknowledges that some States may feel the need to retain the form of title devices to govern the rights of sellers, financial lessors and other suppliers. For this reason, in each of the following subsections of this chapter (A.5-A.11), the relevant issues are examined

as they arise in contemporary legal systems. Each subsection concludes with a review of how the law of acquisition financing could be best reformed, if one or the other of these approaches (unitary or non-unitary) to achieving functional equivalence were adopted.

84. In section B, moreover, this chapter contains parallel recommendations presented as option A and option B. Option A presents recommendations about how States should design the detail of a unitary and functional approach to acquisition financing transactions. The Guide implicitly recommends this approach for States that are enacting legislation to govern the full range of secured transactions for the first time, although States with a comprehensive secured transactions regime can certainly benefit from this approach as well. Option B deals with how States that elect to retain a non-unitary approach should design rules governing acquisition financing through title devices and, in particular, retention-of-title and financial-lease transactions, as well as acquisition security rights, so that the economic advantages of functional equivalence may be equally achieved under a non-unitary approach.

5. Creation (effectiveness as between the parties)

85. The Guide discusses in the chapter on the creation of a security right (effectiveness as between the parties) the requirements for making a security right effective as between the parties (e.g. the grantor and the secured creditor). That chapter also uses the expression “creation” to characterize the requirements necessary to achieve effectiveness as between the parties. As explained in that chapter, the underlying policy is to make the requirements for achieving effectiveness between the parties as simple as possible (see paras. [...]). The precise manner in which these requirements may be transposed to regulating the effectiveness of the rights flowing from an acquisition financing transaction as between the parties will depend on whether a State adopts the unitary or non-unitary approach.

86. In States that continue to recognize retention-of-title transactions and financial leases as distinct security devices, it is, moreover, not obvious that the word “creation” is the most appropriate one to describe how the seller under a retention-of-title transaction or the lessor under a financial lease “acquire” their rights. For example, the lessor’s ownership rights are not created by the contract of lease; the lessor is already the owner at the time it concludes the lease with the lessee. Likewise, the seller that retains ownership is not creating a new right in its favour; it is merely continuing to assert the right of ownership that it had prior to concluding the agreement with the buyer. Nonetheless, for ease of expression, the agreements under which a lessor and a seller may continue to assert their ownership against a lessee or buyer to whom they have granted possession of a tangible asset will sometimes be described as agreements “creating” the acquisition financing rights in question. It may be argued however that, in those States where the buyer under a retention-of-title agreement acquires an expectancy of ownership, a new type of bifurcated ownership is created, and that, consequently, it is appropriate to speak of the “creation” of a retention-of-title right that is not exactly traditional ownership.

87. States that do not treat all acquisition financing transactions in the same way impose widely varying requirements for making acquisition rights effective as between the parties. To begin, the requirements imposed may vary within each State

depending on the specific acquisition financing transaction (retention-of-title, financial lease, security right) in question. In addition, they can vary widely among different States even in respect of the same type of acquisition financing transaction. That is, not all States conceive retention-of-title rights and financial lease rights identically and, therefore, not all impose the same requirement for creating or reserving such a right.

88. As an acquisition financing right, retention of title is usually seen as a property right that arises as part of a contract of sale (such as a clause in one of the documents evidencing the sale). It follows that, in many States, the formal requirements for the creation of a retention-of-title right are those applicable to contracts of sale generally, with no particular additional formalities required. Hence, if a State accepts that a contract for the sale of tangible assets may be concluded orally, the clause of the agreement providing that the seller retains ownership until full payment of the purchase price might also be oral. In such cases, the seller's retention-of-title may be agreed to orally, or by reference to correspondence between the parties, a purchase order or an invoice with printed general terms and conditions. These documents may not even bear the signature of the buyer, but the buyer may implicitly accept the terms and conditions they set out through the taking of delivery of the assets and payment of part of the purchase price as indicated, for example, in the purchase order or invoice. In other States, even though a regular contract of sale may be concluded orally, a writing (even if minimal), a date certain, notarization, or even registration may be required for a retention-of-title clause in a contract of sale to be effective even as between the parties.

89. Credit providers that deploy financial leases, hire-purchase agreements and related transactions also retain ownership because of the nature of those contracts. The effectiveness of, for example, the lessor's right as between the parties will be dependent upon the parties complying with the ordinary formalities for third-party effectiveness applicable to the particular financial lease or hire-purchase agreement in question.

90. In most States, only the actual seller or financial lessor may benefit from a retention-of-title right or a financial lease right (as the case may be) and be required to follow the formalities associated therewith. Other suppliers of acquisition credit, such as lenders, may not directly obtain either a retention-of-title right or a financial lease right. Rather, to do so, they must receive an assignment of the contract of sale from the seller or an assignment of the contract of lease from the lessor. Thus, the formalities for effectiveness of the right claimed by a lender are, first, those applicable to the initial transaction with the buyer or lessee, and second, those applicable to an assignment of that type of contract. In many of these States, it is also possible for a lender that supplies acquisition credit to take a security right. Nonetheless, these States typically do not permit such lenders to acquire the preferred rights of a seller that retains title, or even (in States that permit sellers to take a non-possessory security right), the preferred position that is afforded to sellers that take a security right.

91. There are, however, several reasons why States might wish to permit lenders to accede to the status of acquisition secured creditors directly (that is, without having to take an assignment of a retention-of-title right or a financial lease right, or a seller's own acquisition security right). First, once it is accepted that a buyer may grant security in its expectancy right, there is no reason in principle to restrict

lenders to non-acquisition security transactions. Second, permitting lenders to provide acquisition financing will enhance competition for credit as among sellers, lessors and lenders (which should have a beneficial impact on the availability and the cost of credit). Third, without the possibility of direct, lender-provided acquisition financing, lenders that wish to advance credit to their debtors-buyers against the expectancy right in assets being acquired, will not have a preferred priority position as against other secured creditors on that expectancy right. They will simply rank according to the date their security became effective against third parties. That is, a later-in-time lender that wishes to advance credit specifically to enable a debtor to acquire tangible assets will (in the absence of a subordination agreement) always rank after a general financier that has previously made its security effective against third parties.

92. The various States that do not treat sales with a retention-of-title clause or financial leases as security rights also take differing approaches to the extension of these rights into other assets. In some States, if assets subject to retention of title are commingled with other assets, the retention-of-title right is extinguished (in a few States, by contrast, the retention-of-title continues to be effective as between the parties; in these States, by exception to general principles of property law, as long as similar assets are found in the hands of the buyer, the seller need not undertake any further formality to preserve its right of ownership). Similarly, in most States, the retention-of-title right cannot be extended to assets that are processed or manufactured into new products, while in a small number of other States, the retention-of-title is automatically preserved when the assets are manufactured into a new product. In some States that take the latter approach, the seller is entitled automatically to claim a security right in the new product, while in other States the seller simply becomes an ordinary secured creditor. Some States also permit lessors to continue to claim ownership of leased assets that have been slightly modified or, depending on the terms of the lease, in the proceeds of an authorized disposition. In these cases as well, no additional steps are typically required in order to preserve effectiveness of the security right as between the parties in the modified assets or the proceeds.

93. There is a greater similarity in the principles governing the requirements for effectiveness of acquisition security rights as between the parties among various States that have adopted a fully integrated approach. Indeed, almost no differences in these requirements may be found. Moreover, within each State, the formal requirements for making an acquisition security right effective as between the parties are identical, regardless of whether the financing is provided by a seller, a financial lessor, a lender, or any other person. In addition, because acquisition secured credit is treated simply as a special category of secured financing (that is, because an acquisition security right is a species of security right), these formal requirements will be the same relatively minimal formalities as those required for non-acquisition secured transactions (e.g. a written and signed agreement identifying the parties and reasonably describing the assets sold and their price; see recommendations 13-15). Finally, because the acquisition security right is a security right, it will be automatically preserved in manufactured assets and in proceeds of disposition (see recommendations 19-22).

94. The difference between the two approaches and among the specific legal systems described above rarely lies in a significant way in the writing requirement.

That is, most of them would accept correspondence, an invoice, a purchase order or the like with general terms and conditions, whether they are in paper or electronic form. This is, moreover, the general position concerning a writing requirement that is recommended by the Guide (see recommendations 9 and 10). The difference seems to lie more in the requirement of a signature, which is often required for effectiveness as between the parties. Nonetheless, in some States the buyer's signature is not necessary as long as the retention-of-title seller, acquisition secured creditor or financial lessor is able to demonstrate by other evidence that the buyer or financial lessee has accepted the terms of the agreement. Such evidence could consist merely of the buyer's or financial lessee's acquisition and use of the assets without protest after having received the writing. Also, because so many transactions for the purchase of tangible assets are in fact well documented for other reasons, this issue rarely arises.

95. Under the unitary approach, the requirements for effectiveness as between the parties are the same as those applicable to non-acquisition security rights, and are identical regardless of the legal form (e.g. denominated security right, retention-of-title right, title resolution right, financial lease right) of the transaction (see recommendation 174).

96. If a non-unitary approach were adopted, States seeking to achieve the benefits of a regime that created equal competition for credit would have to develop a regime for creation of an acquisition security right that permits lenders to acquire the same preferred status that is given to retention-of-title sellers and financial lessors. To achieve this result, they would have to ensure that the rules governing effectiveness as between the parties would be functionally equivalent, regardless of the form of the acquisition financing transaction (see recommendation 185). In particular, the rules governing: (a) the capacity of parties to the contract; (b) the specific character and modalities of the obligation secured; (c) the objects upon which the acquisition financing right might be taken; (d) evidentiary obligations such as a writing and signature; and (e) the time of effectiveness of the agreement between the parties would have to be closely coordinated so as not to favour one type of acquisition financing transaction over another (see recommendation 185).

6. Effectiveness against third parties

(a) General

97. The Guide draws a distinction between effectiveness of a security right as between the grantor and the secured creditor and effectiveness of that right as against third parties (see the chapter on creation of a security right, paras. [...], and the chapter on third-party effectiveness of a security right, paras. [...]). The point has a particular importance in relation to acquisition financing rights since, depending on whether a unitary or non-unitary approach is followed, the distinction between these types of effectiveness may not actually exist.

98. Many States that do not treat retention-of-title rights and financial lease rights as security rights do not require these transactions to be registered. Nor do they require the seller or the lessor to take any other formal step beyond what is necessary to make the right effective between the parties in order to ensure its effectiveness as against third parties. To the contrary, in these States, upon the seller and buyer concluding the agreement of sale with a retention-of-title clause, the

seller's ownership right in the tangible assets that has been sold is effective as against all parties.

99. In some States, by contrast, registration of a retention-of-title right and a financial lease right is required (either generally or for particular types of tangible asset). In these States, it is often the case that registration is required only to make the seller's retention-of-title right effective as against third parties. Sometimes, however, no distinction is drawn between effectiveness of the retention-of-title right as between the parties and its effectiveness as against third parties. That is, in some States registration of retention-of-title right is viewed as a requirement for effectiveness even as between the parties. Not surprisingly, a similar diversity of approaches may also be found in relation to the formalities necessary to make a financial lease right effective against third parties.

100. Under all of these retention-of-title regimes, the seller that retains title retains ownership of the assets sold and delivered to the buyer. As a consequence, it will usually be the case that the buyer has no property rights in the assets being purchased until title passes, usually when the purchase price is paid in full. This means that, except in those legal systems in which the buyer has an ownership expectancy right to encumber, no other creditor of the buyer is able to claim rights in the tangible assets being purchased as long as the seller retains ownership. This would be the case even if another creditor provided credit to the buyer to purchase the asset and the value of the buyer's asset subject to the retention-of-title right was higher than the amount of the purchase price still owed to the seller. In such cases, the only asset of the buyer upon which another creditor could claim a security right would be an intangible asset (the right of the buyer to the value of the purchase price paid). An identical outcome would also result in the case of a financial lease. Unless the lease provides for a right of the lessee to buy the leased asset at the end of the lease and thus gives the lessee an ownership expectancy right that the lessee may encumber, the sole asset of the lessee upon which the lessee's creditors could claim security rights would be an intangible asset (the right of the lessee to the value of the rents paid).

101. States that do not recognize the right of a buyer that acquires assets under a retention-of-title transaction or a lessee under a financial lease to grant a security right in the assets purchased or leased either prevent or make it difficult for borrowers to use the full value of either the equity they may have acquired in their tangible assets subject to retention-of-title rights or financial lease rights. That is, the conceptual logic of a retention-of-title or a financial lease agreement disables the buyer from granting a non-possessory security right in the assets being acquired or leased. Interestingly, however, several of these same States permit a purchaser to grant multiple mortgages or hypothecs on immovable assets, with priority based on time of registration, even when the immovable assets have been sold under a retention-of-title transaction and the purchase price has not yet been paid in full.

102. In States that now follow a fully integrated approach, retention of title and its economic equivalents are subject to registration of a notice in the general security rights registry (or to some other formality for making the right effective against third parties) in the same way as any other secured transactions. Under this approach, moreover, the right of the seller that retains ownership by contract, or of the lessor that remains owner by virtue of the nature of the lease, is transformed into the right of an acquisition secured creditor. As a result, the buyer or lessee is able to

use the equity it has in the assets being purchased or leased as security for further credit. That is, the right of the retention-of-title seller or financial lessor that is made effective against third parties is not a right of ownership. It is, rather a security right with the same third-party effectiveness as arises in the case of a seller that sells the tangible assets outright and takes its own security right in the assets sold.

103. Under the unitary approach, the requirements for third-party effectiveness (except in respect of the acquisition of consumer goods; see recommendation 175 and paras. 114-117 below) are the same as those applicable to non-acquisition security rights and are identical regardless of the legal form (e.g. denominated security right, retention of title, title resolution, financial lease) of the transaction (see recommendation 174).

104. If a non-unitary approach were adopted, States would have to ensure that no substantial differences in requirements for third-party effectiveness exist between the different kinds of acquisition financing transactions (see recommendations 185 and 189). A number of rules will have to be closely coordinated so as not to favour one form of transaction over another and, in particular, the rules governing: (a) the modalities by which third-party effectiveness can be achieved; (b) the timing of third-party effectiveness when requirements are met; and (c) the consequences of third-party effectiveness on the right of the buyer or lessee to grant rights in the assets. Specifically, in order to maximize the buyer's or lessee's capacity to benefit from the tangible assets being acquired in the non-unitary approach, States would have to provide that they have the power to grant a security right in the assets subject to the retention-of-title or financial lease right (see recommendation 187).

(b) Third-party effectiveness of acquisition financing transactions generally

105. As noted in the chapter on the effectiveness of a security right against third parties, the general mechanism by which ordinary security rights may be effective against third parties is registration (see recommendation 32). As with ordinary security rights, registration is meant to provide a notice to third parties that such a right might exist and to serve as a basis for establishing priority between competing claimants. Generally, registration promotes credit market competition by providing information that enables financiers to better assess their risks.

106. For this reason, the Guide recommends that third-party effectiveness of all types of acquisition financing transaction (whether denominated as security rights, retention of title, financial leases or in some other manner) should usually be dependant on the registration of a notice in the general security rights registry. This notice would explicitly make mention of the fact that an acquisition security right is being claimed. Where the Guide also recommends other mechanisms to achieve third-party effectiveness for ordinary security rights (e.g. possession, registration in a specialized registry, notation on a title certificate), these mechanisms should also be available as alternative means to achieve third-party effectiveness of acquisition security rights (see recommendations 174 and 185).

107. Under the unitary approach, coordination of the registration of notices relating to acquisition and non-acquisition security rights in the general security rights registry will be necessary to promote certainty in the relative priority of competing claimants. In particular, it will be necessary for creditors to indicate in their notices that they are claiming an acquisition security right.

108. Under the non-unitary approach, the rules governing the registration of a notice with respect to retention-of-title rights and financial lease rights will also have to be coordinated with the general rules relating to the registration of a notice with respect to security rights. Doing so requires either adjusting the former to cohere with the latter or, less plausibly, adjusting the latter to cohere with the former, and establishing a general security rights registry in which notices relating to all such rights can be registered. Together, these steps will ensure certainty in the relative priority of competing claimants that hold different types of acquisition financing rights (for further discussion of the mechanics of registration, see chapter VI, The registry system).

109. The principles that should govern what are called priority conflicts under the unitary approach, including priority conflicts where different methods for achieving third-party effectiveness have been used (see recommendations 176-182), and what are often questions of third-party effectiveness under the non-unitary approach (see recommendations 188-190, 192 and 194) are discussed below in section A.7.

(c) Grace period for the registration of certain acquisition financing transactions

110. Many States historically did not require sellers to take further steps to make their rights effective as against third parties. Similarly, where a seller retained title, it was often not necessary to register the retention-of-title right (with very few exceptions). By contrast, and in keeping with the approach adopted by most States that have recently modernized their secured transactions law, the Guide recommends that registration (or some other step) be taken by sellers, financial lessors or lenders providing acquisition credit in order to achieve third-party effectiveness (see recommendations 174 and 189).

111. Where States require registration in the acquisition financing context, most seek to enhance the efficiency of the registration process by providing sellers and other suppliers of acquisition credit with a short “grace period” (e.g. 20 or 30 days) after delivery of the assets sold or leased to register a notice relating to the acquisition financing transaction in question. Such grace periods are found both in States that do not consider retention-of-title rights and financial lease rights to be security rights and in systems that consider all such rights to be acquisition security rights. Among other advantages, the use of the grace period permits sellers to deliver assets to the buyer without having to wait until they or any other supplier of acquisition credit registers a notice.

112. Under the unitary approach, if the notice is registered within the grace period, the right of an acquisition secured creditor in assets other than inventory has the same priority in relation to other claimants that it would have been able to assert had it registered at or before the time of delivery. This rule may be limited to assets other than inventory, as in the case of inventory, registration and notification of inventory financiers on record has to take place before delivery of the goods (see recommendation 176, alternatives A and B).

113. If a State were to adopt the non-unitary approach, the same rules relating to a grace period for registration and its effects should apply to all acquisition financing transactions, regardless of the legal form of the transaction (e.g. denominated security rights, retention-of-title rights, title resolution rights, financial lease rights) (see recommendation 189, alternatives A and B).

(d) Exceptions to registration for consumer transactions

114. In some States where the registration of a notice relating to acquisition financing transactions would otherwise be required, an exception is made when those transactions relate to consumer goods (for the definition of this term, see Introduction, section B, Terminology). This means that the seller or other supplier of acquisition credit relating to tangible assets bought for the buyer's personal, household or family purposes is not burdened with a requirement to register; nor, as a rule, is the seller or credit supplier in these cases required to follow any of the other steps by which third-party effectiveness is normally achieved. Such transactions become effective against third parties at the same time that they become effective as between the parties. The idea is that in such cases the need to warn potential third-party financiers is less acute (unless consumers quickly resell the goods), especially where the consumer goods are of low value. In other legal systems that generally require registration, only relatively low-value consumer transactions are exempted from the requirement to register (e.g. consumer transactions up to a maximum of Euros 3,000 or its equivalent, or transactions that are subject to the jurisdiction of small-claims courts).

115. In both types of system, the significant market involving automobile finance credit to consumers is usually served by a system that requires registration not in the general security rights registry, but rather in a specialized registry, or that requires the notation of a notice on a title certificate. Moreover, it is important to note that, in States that create an exemption from registration for consumer goods, the exception applies only to consumer transactions. In other words, the exception does not apply to a particular type of asset as such (i.e. consumer goods), but rather only to a type of transaction relating to those assets. It is still necessary to register a notice to achieve third-party effectiveness in assets normally sold to consumers if those assets are being sold to a wholesaler or a retailer as inventory.

116. The exemption from registration does extend to equipment and inventory bought on credit for the buyer's personal, family or household purposes. Nonetheless, if a grace period were adopted for registering the notice of an acquisition financing transaction relating to equipment in the general security rights registry, that grace period may, in itself, serve as the equivalent of an exemption for short-term credit transactions fully paid within the grace period because, as a practical matter, the acquisition financier would not have to register before the expiry of that period. As for equipment-related acquisition financing transactions with longer repayment periods, and inventory-related transactions in general, an exemption may not be necessary if the acquisition financier could register a single notice in the secured transactions registry for a series of short-term transactions occurring over a longer period of time (e.g. five years) (see recommendations 182 and 196). These issues are fully discussed below in section A.7.

117. Under the unitary approach, the exemption from registration (or other method for achieving third-party effectiveness) for consumer transactions would apply regardless of whether the acquisition secured creditor were a seller, lessor or lender since they would all be claiming identical rights. Were a non-unitary approach to be adopted, the rules relating to the exemption from registration (or other method for achieving third-party effectiveness) for transactions relating to consumer goods should produce the same consequences regardless of the legal form

(e.g. denominated security right, retention-of-title right or financial lease right) of the transaction (see recommendations 175 and 188).

7. Priority

(a) General

118. The Guide adopts the term priority to deal with competitions between all persons that may have rights in assets subject to a security right (for the definition of the terms “priority” and “competing claimant”, see Introduction, section B, Terminology). The concept of priority thus includes competitions both with other creditors (secured creditors, other acquisition secured creditors, creditors that may avail themselves of a statutory preference and judgement creditors) and other claimants (including prior owners, buyers, lessees, licensees and the insolvency representative). Nevertheless, some States (and especially some States among those which do not consider retention-of-title rights and financial-lease rights to be acquisition security rights) adopt a more restrictive view of the notion of priority. Only competitions between creditors are considered to involve priority claims. Other potential conflicts (notably between prior owners and subsequent purchasers) are resolved by reference to the right of ownership. This said, however the competition between various potential claimants is characterized, the relative rights of each must be carefully specified.

(b) Priority position of providers of acquisition financing

119. The Guide recommends in the chapter on the creation of a security right (effectiveness as between the parties) that an ordinary security right may be taken in both present and future (or after-acquired) assets (see recommendation 13). It also recommends in the chapter on the priority of a security right that priority generally be determined by the date of registration of a notice with respect to a security right, even in relation to after-acquired assets (see recommendations 73 and 96). In order to promote the provision of new credit for the acquisition of additional assets, it is necessary to establish special rules applicable to competitions between retention-of-title sellers, financial lessors and acquisition secured creditors on the one hand, and pre-existing non-acquisition secured creditors holding rights in future assets of the grantor on the other.

120. In States that do not treat retention-of-title rights and financial lease rights as security rights, the relative priority of rights is decided by reference to the seller's or lessor's right of ownership. The retention-of-title seller or financial lessor effectively prevails with respect to the assets sold over all other competing claimants whose rights derive from the buyer or lessee (except certain bona fide buyers). Moreover, in most such systems, until the buyer or lessee acquires title to the assets (by fully paying the purchase price or, in certain cases, by making the last lease payment), none of the buyer's or lessee's other creditors (including secured creditors claiming a security right in after-acquired assets or creditors attempting to claim an acquisition security right in the assets) are able to claim rights in the assets being purchased or subject to the lease. At best, these secured creditors can claim a right in the value paid by the buyer or lessee, provided they have included that type of intangible asset in the description of the assets covered by their security right. Similarly, judgement creditors and the insolvency administrator may claim the buyer's or lessee's rights, but unless the legal system permits the buyer or financial

lessee to deal with its expectancy right, neither they nor secured creditors can seize the asset itself.

121. Finally, in most such States, there can never be a competition between lenders claiming as providers of acquisition credit and a retention-of-title seller or financial lessor. First, for reasons given, the buyer or lessee has no assets upon which the lender could actually claim an acquisition security right. Second, it is rarely the case that the lender could acquire the expectancy right of the buyer or lessee (for example, by taking a conditional assignment of the right subject to an obligation to retransfer it to the buyer or lessee when the loan is paid); and even if it could take such a right, the right would normally be seen as a type of pledge, or sale with a right of redemption, and not as a right arising in an acquisition financing transaction. Were a legal system to permit such transactions, the lender that acquired the ownership expectancy right would have a right that could be set up as against any other claimants asserting rights derived from the buyer or lessee (including buyers, secured creditors, judgement creditors and the insolvency representative), although not as against the retention-of-title seller or financial lessor. In other words, in these legal systems, the primary (if not the only) way in which a lender could acquire a preferred status as against other creditors and claimants would be to purchase the seller's or lessor's retention-of-title or financial lease right.

122. In States that follow the fully integrated approach, the priority rights of a seller or a lessor that provides acquisition financing are equally protected. Provided that the retention-of-title seller, financial lessor or similar title claimant registers a notice in the general security rights registry within a short grace period and, in the case of inventory, takes certain other steps discussed below, they will have priority over all other claimants (except certain bona fide buyers). Moreover, in these States, a lender that provides financing to enable a buyer to purchase assets will also be an acquisition secured creditor with priority over other claimants in the same manner as a seller or lessor. This means that, unlike the situation in States that do not follow the fully integrated approach, there can be more than one creditor claiming an acquisition security right. As a consequence, under the fully integrated approach, a further priority rule is necessary to deal with these cases. Invariably, these States provide that the seller that purports to retain title, the financial lessor, and the seller that transfers title but takes an ordinary acquisition security right will have priority over any other supplier of acquisition financing, even if that other financier (e.g. a bank or other lender) had made its acquisition security right effective against third parties before the seller or lessor did so. Thus, in States that follow the fully integrated approach, the seller and lessor are able to achieve the same preferred priority position in relation to all other claimants as the retention-of-title seller or finance lessor in a non-unitary system.

123. While rights under acquisition financing transactions will normally be made effective against third parties by registration in the general security rights registry, many States also contemplate other methods for achieving third-party effectiveness. In these States, one such method (i.e. possession by the secured creditor) will generally produce the same consequences as registration, and may be looked upon as an alternative to registration. As a result, should a supplier of acquisition financing such as a retention-of-title seller, a financial lessor or a seller that takes an acquisition security right make its rights effective against third parties by possession within the stipulated grace period (given the purposes of acquisition financing, a

highly implausible but theoretically possible situation), the general priority principle would be applicable. Where States also permit lenders to obtain acquisition security rights, an identical outcome would result (see recommendations 174 and 185).

124. Where the non-acquisition secured creditor makes its security right effective against third parties by registration in a specialized registry, the Guide recommends that the registration in the specialized registry will give the registering creditor priority over even prior registrations in the general security rights registry or third-party effectiveness achieved by a prior possession (see recommendation 74). In order to enhance the usefulness of the specialized registries, a similar rule should apply to suppliers of acquisition financing. They should not be able to obtain a preferred priority position simply by registration in the general security rights registry or possession within the grace period (see recommendation 177). By implication, it would follow that, as a general principle, and subject to any superseding law, an acquisition security right that is registered in the specialized registry would have priority over even a prior non-acquisition security right registered in that specialized registry. Nonetheless, in States that do not treat retention-of-title and financial lease rights as security rights, a certain nuance is necessary. In these States, the retention-of-title seller or financial lessor will be the party that is registered as owner in the specialized registry. No other creditor of the buyer or lessor can register a security right in that register, so the seller or lessor will achieve priority simply by virtue of its registered ownership right. Only in cases where the seller transfers title to the buyer and takes an acquisition security right would the principle relating to the priority of registration in specialized registries be applicable.

125. Under the unitary approach, all acquisition secured creditors are subject to the same priority regime and must take identical steps in order to assure their priority position. Having done so, they are entitled to claim priority over even pre-existing creditors that have non-acquisition security rights in the grantor's after-acquired (or future) assets. Because the acquisition security right overcomes the general rule that fixes priority based on the time of registration, this preferred position of an acquisition security right is often referred to as a "super-priority". In a competition between acquisition secured creditors that have all taken the necessary steps to make their rights effective against third parties, the time of registration will generally determine their relative priority under the same principles as apply to non-acquisition security rights (see recommendations 174 and 176). The only difference between different categories of acquisition secured creditors is that in a competition between a seller or a lessor and another creditor, all of whom are asserting an acquisition security right, the seller or lessor would always have priority, regardless of the respective dates of registration of their rights (see recommendation 178).

126. If the non-unitary approach were adopted to achieve functional equivalence, States would likely have to make slight adjustments to their existing regime. First, it would be necessary to permit providers of acquisition financing, other than retention-of-title sellers and financial lessors, to acquire the preferred priority status of sellers and lessors by taking an acquisition security right. In such cases, it is important that equivalent rules relating to the priority of the seller's or lessor's rights are established regardless of the legal form (e.g. denominated security right, retention of title, title resolution, financial lease) of the transaction

(see recommendations 184 and 185). Second, and concomitantly, in a competition between a retention-of-title seller, finance lessor or seller that takes an acquisition security right and a supplier of acquisition financing that is not a seller or lessor, it would be necessary to ensure that priority goes to the seller or lessor, regardless of the time at which these various acquisition financing rights and acquisition security rights were registered (see recommendation 195). This will follow as a matter of course in cases involving a seller that retains title or a financial lessor, but where the seller transfers title and takes an acquisition security right, it would be necessary to specify that the seller's acquisition security right will always have priority over any other acquisition security right.

(c) Priority of acquisition financing rights in consumer goods

127. The general priority principles just noted establish a framework for organizing the rights of providers of acquisition financing where more than one of them may be in competition over the same tangible asset. However, not all tangible assets serve the same economic purpose and are subject to the same business dealings. Consequently, many States have drawn distinctions between types of such assets (notably, between equipment and inventory, but often between commercial assets and consumer goods as well) in the non-acquisition financing context. For example, in some States, different denominated security devices are available depending on the type of asset (an agricultural or commercial pledge for equipment, a transfer-of-property-in-stock and a floating charge for inventory). In States with fully integrated systems involving a generic concept of a security right, these different types of security device have disappeared. However, even in such States, the distinctions between different types of asset remain where acquisition security rights are an issue. Thus, it is instructive to examine how States have addressed acquisition financing in relation to different categories of asset.

128. The Guide recommends, by exception to the general rule, that the rights of providers of acquisition financing for consumer goods be effective as against third parties without registration in the general security rights registry or creditor possession (see recommendation 175 and 188). In other words, the relevant time for fixing effectiveness against third parties is the time when the agreement was effective between the seller, lessor or lender and the buyer, lessee or borrower, as the case may be. Consequently, the priority of a retention-of-title right or financial lease right over any non-acquisition security right created by the buyer, lessee or borrower is acquired automatically from the moment the right becomes effective as between the parties.

129. Under the unitary approach, providers of acquisition financing for consumer goods are able to claim a super-priority over non-acquisition secured creditors without the need to make the right effective against third parties by registration or possession (see recommendation 175).

130. States that adopt a non-unitary approach would have to provide equivalent rules giving priority to the seller's or lessor's rights over pre-existing rights in consumer goods regardless of the legal form (e.g. denominated security right, retention-of-title right or financial lease right) of the transaction. This priority could find its source either in the seller's or lessor's ownership, or in the case of a seller or lender that takes an acquisition security right, in the general principle that applies to acquisition security rights in consumer goods (see recommendation 188).

(d) Priority of acquisition financing rights in tangible assets other than inventory or consumer goods

131. As noted, in most States that do not consider retention-of-title and financial lease rights to be security rights, the issue of competition between providers of acquisition financing and between acquisition and non-acquisition financiers does not normally arise. Pre-existing non-acquisition secured creditors are rarely permitted to acquire rights in assets of which the grantor is not yet owner, and other lenders are generally not entitled to claim a special priority when they finance a buyer's acquisition of tangible assets. Moreover, even where it is possible to take a security right in the expectancy of ownership, that expectancy will only mature once the seller or lessor is fully paid. Only at this point can there be a real competition between claimants that derive their rights from the buyer or lessee (e.g. secured creditors, judgement creditors, the insolvency representative, buyers and lessees). Where, however, the seller itself takes an acquisition security right rather than retaining title and is in competition with a pre-existing non-acquisition security right, it is necessary to provide rules to determine when the seller's acquisition security right will have priority. Where equipment is involved, there is typically a single asset (or at most a relatively small number of individually identifiable assets) being sold or leased, and these assets are normally not meant to be resold in the short term. For this reason most States do not require retention-of-title sellers or financial lessors of equipment to take any further steps beyond those necessary to achieve third-party effectiveness as a condition of asserting their ownership.

132. In States that follow a fully integrated approach, the protection of the acquisition secured creditor's rights will have a common basis. Upon registration, before or within a grace period after delivery of the tangible assets to the grantor, the acquisition security right in the new equipment is given priority over pre-existing security rights in future equipment of the grantor. Moreover, in these States as well, because equipment financing usually involves either a single asset (or at most a relatively small number of individually identifiable assets) not normally meant to be resold in the short term, acquisition secured creditors are typically not required to take any further steps beyond those necessary to achieve third-party effectiveness as a condition of asserting their acquisition security right.

133. Under the unitary approach, all acquisition secured creditors of equipment are able to claim a super-priority over non-acquisition secured creditors for their acquisition security right, provided that they register a notice indicating that they are claiming such a right in the general secured rights registry within the stipulated grace period (see recommendation 176).

134. States that adopt the non-unitary approach would have to provide equivalent rules relating to the priority (or, in the terminology of the non-unitary approach, the third-party effectiveness) of the seller's or lessor's rights over pre-existing rights in future equipment regardless of the legal form (e.g. denominated security right, retention-of-title right or financial lease right) of the transaction. That is, even though the buyer or lessee is authorized to grant a security right in equipment over which it will only have an expectancy right until the purchase price is fully paid or the financial lease concludes, and even if that security right covers future or after-acquired equipment and is made effective against third parties prior to the date of the sale, the retention-of-title seller (or similar acquisition financier) will have priority if it registers a notice of its rights within the same grace period given to an

acquisition financier. Similarly, under this approach, a seller that transfers title but retains an acquisition security right, or a lender that supplies acquisition financing and takes an acquisition security right, will also have priority if it registers a notice within the indicated grace period (see recommendation 189).

(e) Priority of acquisition financing rights in inventory

135. Frequently, the competition between a supplier of acquisition financing and a non-acquisition security right arises in relation to inventory. In such cases, different policy considerations from those applicable to the acquisition of equipment are at issue. Unlike equipment financiers, inventory financiers typically extend credit in reliance upon a pool of existing or future inventory on a short-term basis and perhaps even on a daily basis. The pool of inventory may be constantly changing as some inventory is sold and new inventory is manufactured or acquired. In order to obtain a new inventory credit, the grantor usually would present the lender with invoices or certifications indicating the actual status of the inventory serving as security for the new credit.

136. In States that do not treat retention-of-title and financial lease rights as security rights, the relative priority (or third-party effectiveness) of rights is decided by reference to the seller's or lessor's right of ownership. It is implausible that inventory would be acquired under a financial lease, since the principal characteristic of inventory is that it will be sold. In cases involving retention-of-title rights, the position of a lender that finances the acquisition of inventory is especially precarious. Future advances will usually be made on the assumption that all new inventories are acquired under a retention-of-title transaction. It then becomes necessary for the creditor to determine what inventory has actually been fully paid. This has the effect of complicating a borrower's efforts to obtain future advances secured by the pool of inventory. Nonetheless, the seller will have priority based on its ownership for inventory not yet paid for; only once the inventory is paid for by the buyer may other creditors assert security rights in that inventory.

137. In States that follow the fully integrated approach, the rights of the general inventory financier are more secure. Where the additional assets acquired by the grantor are inventory, the acquisition security right will have priority over a non-acquisition security right in future inventory if the registration of a notice in the general security rights registry is made prior to the delivery of the inventory to the grantor. In addition, in some States that follow the fully integrated approach, pre-existing inventory financiers that have registered their rights must be directly notified that a higher-ranking acquisition security right is being claimed in the new inventory being supplied. The reason for this rule is that it would not be efficient to require the non-acquisition inventory financier to search the general security rights registry every time it advanced credit in reliance upon a pool of ever-changing inventory. In order to avoid placing an undue burden on acquisition secured creditors, however, a single, general notification to pre-existing non-acquisition inventory financiers on record may be effective for all shipments to the same buyer occurring during a significant period of time (e.g. five years or the same period that registration lasts to make a security right effective against third parties). This would mean that, once notification had been given to these pre-existing non-acquisition inventory financiers, it would not be necessary to give a new notification within the

given time period for each of the multiple inventory transactions between the acquisition secured creditor and the party acquiring the inventory.

138. Under the unitary approach, the additional requirements usually found in States that now follow the fully integrated approach are adopted for acquisition security rights in inventory. That is, acquisition secured creditors are able to claim a super-priority over non-acquisition inventory financiers for their acquisition security right only if, prior to the delivery of the inventory to the grantor, they register a notice in the general security rights registry indicating that they are claiming an acquisition security right and they also notify in writing earlier registered non-acquisition financiers (see recommendation 176, alternative A). Under this approach, acquisition secured creditors do not have a grace period after the buyer obtains possession of the assets within which they may register a notice that they are claiming an acquisition security right.

139. While all States that have to date adopted the fully integrated approach take the above view, it is possible to imagine that no distinction should be drawn between inventory and assets other than inventory and consumer goods. If such were the case, the principles governing assets other than inventory would also apply to acquisition security rights in inventory. In order to maintain parallelism between the unitary and non-unitary approaches, the Guide presents these options in recommendations 176 and 189 as alternative A and alternative B.

140. If a State were to adopt a non-unitary approach, it would face a similar choice. Under alternative A in recommendation 189 of the non-unitary approach, equivalent rules relating to the priority of the seller's rights over pre-existing rights in future inventory should be established regardless of the legal form (e.g. denominated security right, retention-of-title right or financial lease right) of the transaction. That is, notwithstanding that the retention-of-title seller remains the owner of the assets delivered, the rules governing the sale of inventory should be adjusted so that the seller's title will have priority over pre-existing rights in future inventory only under the same conditions as its rights would have priority were they to arise under an acquisition security right taken by that seller (see recommendation 189). In other words, under alternative A, the retention-of-title seller or the seller or lender claiming an acquisition security right would be required, prior to delivery of the inventory to the buyer, to register a notice indicating that it is claiming an acquisition security right in the general security rights registry and also notify in writing earlier registered non-acquisition financiers.

141. Under alternative B in recommendation 189 of the non-unitary approach as recommended in the Guide, no distinction would be drawn between equipment and inventory. A retention-of-title seller, or a seller or lender claiming an acquisition security right in inventory, would only be required to register a notice indicating that it is claiming an acquisition security right in the general security rights registry either before, or within the indicated grace period after, the buyer obtains possession of the assets.

(f) Multiple acquisition financing transactions

142. In many situations, a seller or other supplier of acquisition financing will provide financing to permit the acquisition of several assets. This could involve, for example, multiple sales with multiple deliveries of inventory or multiple sales of

several pieces of equipment. In these situations, it is necessary to decide, as a matter of policy, whether the supplier of acquisition financing should benefit from its special priority rights over all equipment or inventory financed by it, without the need to identify the purchase price due under each particular sale. If so, the legal system in question is said to permit “cross-collateralization”.

143. In most States that do not treat retention-of-title transactions and financial leases as security devices, the issue of cross-collateralization usually does not arise. In the normal case of a retention-of-title sale or similar title transaction, the contract of sale or lease applies only to the specific assets sold or leased under that contract. Thus, while the same agreement may cover multiple deliveries, it would not cover multiple sales. The priority claim of the seller or lessor as owner would relate to the specifics of each sale or lease. Some of these States do, however, permit the retention-of-title right to be enlarged by providing, for example, that the parties may agree to an “all monies” or “current account” clause where inventory is being sold. When such clauses are used, the seller retains ownership of the assets sold until all debts owing from the buyer to the seller have been discharged and not just those arising from the particular contract of sale in question. In some States, however, retention-of-title sales with “all monies” or “current account” clauses are often characterized by courts as security devices.

144. In States that follow the fully integrated approach, the usual rule is that the super-priority of acquisition security rights, at least in inventory, is not impaired by cross-collateralization. This means that the acquisition secured creditor may claim its preferred priority position in relation to the financed inventory without being obliged to specifically link any outstanding indebtedness to any particular sale or lease transaction. In such cases, the special priority right does not extend to other inventory or assets, the acquisition of which was not financed by that acquisition secured creditor.

145. Under the unitary approach, the goal is to permit a maximum of flexibility to acquisition secured creditors that provide financing for the acquisition of inventory, and to minimize the transactional paperwork associated with multiple acquisition transactions involving the same acquisition secured creditor. For this reason a single registration will be sufficient to cover multiple transactions and a single notice sent to creditors with security rights in after-acquired inventory of the type being supplied may cover acquisition security rights under multiple transactions between the same parties without the need to identify each transaction (see recommendations 65, 175 and 176, alternative A, subparagraph (c), and alternative B, subparagraph (b)).

146. Under the non-unitary approach, because a contract of sale or lease normally applies only to the specific assets sold, it would be necessary to modify the rules relating to retention-of-title rights and financial lease rights so as to permit cross-collateralization. Moreover, under alternative A of recommendation 189 in relation to inventory, should a seller or any acquisition secured creditor that is not a seller take an acquisition security right in the assets, the seller or other financier should be enabled to exercise a right of cross-collateralization in the same manner as under the unitary regime (see recommendation 190). Should alternative B of recommendation 189 be adopted, no notification of the retention-of-title, financial lease or acquisition security right would have to be sent in order for the supplier of acquisition finance to claim the preferred priority position.

(g) Priority of rights of acquisition financing providers as against the rights of judgement creditors

147. In the chapter on the priority of a security right, the Guide recommends that the rights of creditors that obtain a judgement and take the steps necessary to acquire rights in a judgement debtor's assets will generally have priority over existing security rights for advances made after the existing secured creditors are informed of the judgement creditor's rights (see recommendation 81). When the competing right in question is a retention-of-title right, a financial lease right or an acquisition security right, a slightly different set of considerations, depending on the kind of tangible assets at issue, must be taken into account. For example, if the tangible assets are consumer goods, the provider of acquisition financing is not required to register or take possession of the assets in order to make its rights effective against third parties. Hence the retention-of-title seller or financial lessor as an owner upon conclusion of the transaction will not be in a priority competition with a judgement creditor since the judgement creditor cannot seize the assets of a person other than its debtor. Similarly, in the case of consumer goods, conflicts between an acquisition secured creditor and a judgement creditor will be rare since the consumer transaction will rarely involve future advances.

148. If the assets are inventory, the provider of acquisition financing must have possession of the assets or have registered its rights and notified already registered third parties of its rights prior to the buyer obtaining possession of the inventory. Hence the judgement creditor will always be on notice of the acquisition financier's or acquisition secured creditor's potential rights. However, in one case (that involving equipment), the provider of acquisition financing is given a grace period within which to register its rights. Nonetheless, as in the case of consumer goods, it is seldom the case that a provider of acquisition financing for equipment will be making future advances. This said, when a judgement creditor seeks to enforce its judgement against its debtor's assets, it should not generally be able to defeat the rights of a provider of acquisition financing that adds new value to the judgement debtor's estate.

149. If the unitary approach is adopted, it should be provided that, as long as an acquisition secured creditor makes its rights effective against third parties within the grace period, it will have priority even over judgement creditors that register their judgement during that grace period (see recommendation 179).

150. If the non-unitary approach is adopted, a similar protection should be afforded to retention-of-title sellers, financial lessors and acquisition secured creditors that register a notice of their acquisition security right within the indicated grace period (see recommendation 189). If alternative A were adopted, this principle would apply only in the case where the acquisition of equipment is being financed. By contrast, if alternative B were adopted, the grace period would also apply to inventory, and the recommendation would apply to cases where the acquisition of either equipment or inventory is being financed.

(h) Priority of rights of acquisition financing providers in attachments to movable property and masses or products

151. The Guide recommends in the chapter on the priority of a security right that a security right in an attachment to movable assets that is made effective against

third parties by registration in a specialized registry or by a notation on a title certificate has priority against a security right in the related assets that is registered subsequently in the general security rights registry (see recommendation 86). This recommendation rests on the fact that security rights that are effective against third parties remain effective even after the assets that they encumber have become attached to other assets. In such cases, if two or more security rights encumber the assets at the time of attachment, they would maintain their relative priority following attachment. In respect of a mass or product (or, in other words, commingled assets), the Guide recommends that the security rights continue into the mass or product, and if there are two or more, they retain their relative priority in the mass or product (see recommendation 87).

152. In both situations, however, it is also necessary to determine the relative priority of rights taken in the different tangible assets that are united by attachment or commingled. The Guide provides that the regular priority rules apply so that the time of registration in the general security rights registry would determine priority, unless one of the security rights was an acquisition security right. An acquisition security right taken in a part of commingled assets would have priority over an earlier registered non-acquisition security right (and presumably even an acquisition security right) granted by the same grantor in the whole mass or product (see recommendation 89). The Guide does not, however, take a position on whether an acquisition security right in an attachment should have priority over an earlier-registered non-acquisition (or even acquisition) security right granted by the same grantor in the tangible assets to which the attachment is attached.

153. In States that do not consider retention-of-title rights and financial lease rights as security rights, the general priority rules set out in the chapter on priority of a security right would not directly apply to acquisition financing. That chapter deals with situations where all forms of secured transaction are treated as security rights under the general unitary and functional approach. In the acquisition financing context, however, the relative rights of the parties depends on general rules of property law governing attachments. Normally, if the attached asset can be detached without damaging the assets to which it is attached, the retention-of-title seller would retain its ownership in the attachment. If the attachment could not be so removed, it is necessary to determine whether the attachment or the asset to which it is attached is the more valuable. If the tangible asset in which a seller has retained ownership is more valuable, the retention-of-title seller acquires ownership of the whole, subject only to an obligation to pay the value of the other asset. Conversely, if the tangible asset in which a seller has retained ownership is less valuable, the retention-of-title seller loses its ownership and merely has a claim against the new owner for the value of its former asset.

154. Under the unitary approach, acquisition secured creditors with rights in attachments or in assets that are commingled are generally able to claim a super-priority over non-acquisition secured creditors. That is, they will have priority over other secured creditors claiming a right in the attachment or in the tangible assets that are being commingled or processed. They will also have priority over non-acquisition secured creditors of the assets to which the attachment is attached, at least in so far as the value of the attachment is concerned, and they will have priority over non-acquisition secured creditors with security over the entire mass or product (see recommendations 87-89).

155. If a State were to adopt the non-unitary approach, equivalent rules relating to the priority of the seller's rights over other rights in the attachment or the tangible assets to be commingled or processed should be established regardless of the legal form (e.g. denominated security right, retention-of-title right or financial lease right) of the transaction. In other words, notwithstanding that the retention-of-title seller of an attachment might lose its ownership upon attachment, the seller should be able to claim its priority either in the share of the mass or product that it sold, or upon the attachment that it sold. The exact mechanism by which the rules of attachments to movable assets would have to be adjusted depends on the detail of the law in each particular State that chooses to adopt the non-unitary approach.

(i) Priority of rights of acquisition financing providers in attachments to immovable property

156. In the chapter on the priority of a security right, the Guide recommends that, after attachment, a security right in attachments to immovable property that is made effective against third parties under immovable property law has priority over a security right in those attachments made effective against third parties under the law relating to secured transactions. Conversely, if the security right in tangible assets is made effective against third parties before attachment and is registered in the immovable registry, it will have priority over subsequently registered security rights in the immovable property (see recommendations 84 and 85). The logic of these provisions should also apply to retention-of-title rights, financial lease rights and acquisition security rights.

157. The rights of a provider of acquisition financing in a tangible asset that will become an attachment should have priority over existing encumbrances on the immovable property provided that a notice of the right of the acquisition financing provider is registered in the immovable registry within a reasonable period after attachment. In this case, the person claiming an existing encumbrance on the immovable property made its advances on the basis of the value of the immovable property at the time of the advances and has no pre-existing expectation that the attachment would be available to satisfy its claim. In cases where the pre-existing encumbrance on the immovable property secures a loan that is intended to finance construction, this same assumption would not hold, and the rationale for preserving the preferred priority of the supplier of acquisition financing is less compelling.

158. Under the unitary approach, a single rule governing these cases is possible since the claim of the acquisition secured creditor will always be a security right (see recommendation 180). The acquisition secured creditor that takes the steps necessary to make its right effective against third parties will have priority, except as against a construction loan that is secured by the immovable property.

159. Should a State adopt the non-unitary approach, however, it will be necessary to adjust the rules relating to attachments to achieve a result that is functionally equivalent regardless of the form of the transaction. That is, it would be necessary to specify that the retention-of-title right and a financial lease right will normally continue to be effective against third parties with existing rights in the immovable property, provided they register their rights in the immovable property registry within a short time after the asset becomes an attachment to the immovable property. By contrast, the retention-of-title seller and financial lessor would lose their priority to a construction financier even when the title to the assets being

attached does not automatically pass to the owner of the immovable property (as would be the case for assets sold under retention of title or leased under a financial lease that is fully incorporated into the immovable property) (see recommendation 192). Likewise, a seller or lender with an acquisition security right will have priority should it re-register its rights in the immovable property registry within the same short period.

(j) Acquisition financing priority in proceeds generally

160. In many cases, the supplier of acquisition financing knows that the buyer will resell the assets being acquired. This is obviously the case with inventory, but sometimes a manufacturer or other business enterprise will sell existing equipment in order to acquire upgraded equipment. As discussed in the chapter on the creation of a security right, an ordinary security right in tangible assets will normally extend into the proceeds of its disposition (see recommendation 19). In the case of acquisition financing, this extension of a security right into proceeds raises three distinct policy questions. The first relates to whether a similar extension into proceeds should be possible where the acquisition financing is by way of retention-of-title right or financial lease right. The second policy question is whether the special acquisition financing priority should also extend to proceeds. The third policy question is whether the rules for making such a claim should be the same regardless of whether equipment or inventory is being purchased.

161. While it is extremely rare, some States that do not treat retention-of-title rights and financial lease rights as security rights permit the seller or lessor to extend its ownership claim into proceeds generated by the sale of the assets when these proceeds are tangible assets of the same type as sold, for example, a vehicle received by the seller as a trade-in upon the purchase of a new vehicle. When the proceeds of disposition are in the form of receivables, the ownership right is invariably extinguished. Nonetheless, in some States, the retention-of-title right and financial lease right in intangible proceeds are converted into a security right, although, once again this is not the common practice.

162. The Guide takes the position that a retention-of-title right or a financial lease right should permit the seller or lessor to claim a right in proceeds and that, consistent with the position found in almost all of those few States which already extend the retention-of-title right into proceeds, this right should always be a security right and not a continuation of the ownership right (see recommendation 193). The second and third policy questions relating to proceeds of assets sold under retention-of-title or subject to a financial lease are discussed in the next two subsections.

(k) Acquisition financing priority in proceeds of tangible assets other than inventory or consumer goods

163. In States that do not treat retention-of-title rights and financial lease rights as security rights, the issue of a seller or lessor claiming special rights in proceeds generated by the sale of equipment, while theoretically possible, usually does not arise. This is because the law of sale or lease usually limits the seller's retained ownership right or the lessor's ownership only to the assets sold or leased. In cases of unauthorized disposition, the seller or lessor may be able to recover the asset in kind from the person to which it has been transferred. However, sometimes the

assets cannot be found, even though assets or money received for their disposition can be identified. In addition, sometimes the seller or lessor permits the sale on condition that the seller's or lessor's title is extended to the proceeds of the assets in which the seller or lessor retained title. As noted, in these two situations, very few States permit the seller or lessor to claim ownership by real subrogation into the proceeds of the assets sold under a retention-of-title or financial lease transaction that are tangible assets of the same type. Where the contract is a sale, it is common to speak of the seller's rights as an "extended retention of title". In the majority of cases where such an extension is possible, however, the retention-of-title right or financial lease right is converted into a security right in the proceeds.

164. In some States that follow the fully integrated approach, the special priority of an acquisition security right extends only to the assets the acquisition of which is financed, while in other States the special priority may extend to its identifiable proceeds as well, at least in the case of transactions relating to equipment. Since the grantor does not usually acquire equipment with a view to immediate resale, there is little concern about prejudicing other secured creditors if the special priority of an acquisition security right in equipment is extended to the proceeds of its disposition. If the equipment becomes obsolete or is no longer needed by the grantor, and is later sold or otherwise disposed of by the grantor, the secured creditor will often be approached by the grantor for a release of the security right to enable the grantor to dispose of the equipment free of the security right. Absent that release, the disposition would be subject to the security right and it would be unlikely that a buyer or other transferee would pay full value to acquire the equipment. In exchange for the release, the secured creditor will typically control the payment of the proceeds, for example by requiring that the proceeds of the disposition be paid directly to the secured creditor for application to the secured obligations. Under these circumstances, it is unlikely that another creditor would rely upon a security right taken directly in an asset of the grantor that represents proceeds of the disposition of the equipment initially subject to an acquisition security right.

165. Under the unitary approach, the assumption is that equipment is not normally subject to ongoing turnover. The acquisition secured creditor's control over the disposition of the asset supports the conclusion that the special priority afforded to acquisition secured creditors should be extended into proceeds of disposition and products of the assets covered by the acquisition security right (see recommendation 181).

166. If a State adopts the non-unitary approach, the rules relating to the maintenance of a special priority in proceeds of equipment should produce the same consequences as against other claimants regardless of the legal form (e.g. denominated security right, retention-of-title right or financial lease right) of the acquisition financing transaction. That is, the special priority of the retention-of-title seller or lessor of equipment should be claimable in the proceeds of disposition, either by continuing the seller's or lessor's title in the proceeds or by giving the seller or lessor a replacement security right with the same priority claim as a seller or lender that took an acquisition security right. It would also be necessary to provide for the third-party effectiveness of this replacement right in proceeds through rules relating to a registration of a notice or another method for achieving third-party effectiveness, as well as to provide that, in such cases, this right has the

same priority against other claimants as if it were an acquisition security right taken by a seller or a lender (see recommendation 195).

(I) Acquisition financing priority in proceeds of inventory

167. The situation in relation to proceeds of inventory is different from that relating to proceeds of equipment for three reasons. First, inventory is expected to be sold in the ordinary course of business. Second, the proceeds of the sale of inventory will predominantly consist of receivables rather than some combination of a trade-in and receivables. That is, to take an example, it would not normally be the case that a seller of clothing or furniture would take back the purchaser's used clothing or furniture in partial payment of the purchase price. Third, it will often be the case that a pre-existing secured creditor, in extending working-capital credit to the grantor, will be advancing credit to the grantor on a periodic or even daily basis in reliance upon its superior security right in an ever-changing pool of existing and future receivables as original encumbered assets. It may not be possible or practical for the grantor to segregate the receivables that are the proceeds of the inventory subject to an acquisition financing right or an acquisition security right from other receivables over which a pre-existing creditor has taken a security right. Even if it were possible or practical for the grantor to segregate the proceeds generated by the disposition of inventory over which an acquisition financing right or an acquisition security right had been granted, it would have to do so in a way that was transparent to both financiers and that minimized monitoring by both financiers.

168. Without such a prompt segregation that is transparent to both financiers and that minimizes monitoring, there is a significant risk that the pre-existing secured creditor extending credit against receivables would mistakenly assume that it had a higher-ranking security right in all of the grantor's receivables. There is likewise a risk of a dispute between the pre-existing secured creditor and the retention-of-title seller, financial lessor or acquisition secured creditor as to which financier has priority in which proceeds. All of those risks and any concomitant monitoring costs may result in the withholding of credit or charging for the credit at a higher cost. If the priority of the provider of acquisition financing in the inventory does not extend to the proceeds, that provider of acquisition financing may itself withhold credit or offer credit only at a higher cost.

169. However, that risk may be ameliorated in a significant respect. For example, if the priority of the acquisition financing right or acquisition security right in the inventory does not extend to the receivables proceeds, a pre-existing secured creditor with a prior security right in future receivables of the grantor will be more likely to extend credit to the grantor in reliance upon its higher-ranking security right in the receivables to enable the grantor to pay for the inventory acquired by the grantor. The amount of the advance by the pre-existing secured creditor should be sufficient for the grantor to pay the purchase price to the seller of the inventory. This is because usually advance rates against receivables generally are much higher than those against inventory and because the amount of the receivables reflects a resale price for the purchase of the inventory well in excess of the cost of the inventory to the seller. Thus, there is a greater likelihood that the purchase price will be paid on a timely basis.

170. Under the unitary approach, the complexity of determining what receivables arise from the disposition of assets in which an acquisition security right exists, and

the widespread use of receivables as assets subject to a separate security right, are cogent reasons why the special priority afforded to acquisition security rights in inventory should be limited to proceeds of disposition other than receivables and other payment rights (e.g. negotiable instruments, rights to payment of funds credited to a bank account, and rights to receive the proceeds under an independent undertaking; see recommendation 182).

171. While all States that have to date adopted the fully integrated approach take the above-mentioned view, it is possible to imagine that no distinction should be drawn between proceeds of inventory and proceeds of assets other than inventory and consumer goods. If such were the case, the principles governing assets other than inventory would also apply to acquisition security rights in inventory. However, because the right in proceeds would also extend to receivables and other payment rights, the security right in proceeds would not have the special priority of an acquisition security right but would only have priority according to the general rules applicable to ordinary security rights. In order to maintain parallelism between the unitary and non-unitary approaches, the Guide presents these options in recommendations 182 and 196 as alternative A and alternative B.

172. Should a State adopt the non-unitary approach as recommended in the Guide, it would face the same choice. Under alternative A, the special priority given to acquisition financiers and acquisition secured creditors should not be extended to proceeds of disposition in the form of receivables and other payment rights regardless of the legal form of the acquisition financing transaction (e.g. denominated security right, retention-of-title right or financial lease right). In particular, the special priority of the retention-of-title seller of inventory should be claimable only in other tangible assets, and not in proceeds of disposition of that inventory that take the form of receivables and other payment rights (see recommendation 196, alternative A). By contrast, under alternative B, the retention-of-title seller, financial lessor or acquisition secured creditor would be able to claim a security right in the proceeds of disposition of that inventory, including proceeds that take the form of receivables and other payment rights, but it would only have priority according to the general rules.

[Note to the Commission: The Commission may wish to note that the alternatives in recommendations 182 and 196 are presented in a note as the matter has not yet been considered by the Commission. Paragraphs 167-172 may need to be revised to reflect the final decision of the Commission on this matter.]

(m) Priority as between rights of competing providers of acquisition financing

173. In the various priority conflicts already described in this section, the competing claimants are asserting different rights in tangible assets. That is, the conflicts are between the rights of a retention-of-title seller, financial lessor or an acquisition secured creditor and mainly a non-acquisition secured creditor. In a few cases, however, the competition could be between two claimants, each of whom is asserting rights arising from an acquisition financing transaction. The main circumstance in which, depending on the applicable law of a given State, this may occur is when a lender provides credit to a buyer in order to make a down payment, and the seller also offers credit terms to the purchaser for the remainder of the purchase price.

174. In States that do not treat retention-of-title rights and financial lease rights as security rights, the relative priority of claims is decided by reference to the seller's or lessor's right of ownership. Unless that system permits other creditors to take a security right in the expectancy right of the buyer, a competition between owners and secured creditors would not arise. Further, even if it were possible for a creditor to take a security right in a buyer's or lessee's expectancy right, that expectancy right will only mature once the seller or lessor is fully paid. In other words, in most States with such systems, there can never be a direct competition between a lender claiming rights under an acquisition financing transaction and a seller or lessor. The only way that a lender could acquire an acquisition financing right would be to obtain an assignment of the secured obligation from the retention-of-title seller or the financial lessor.

175. Furthermore, in States that do not treat retention-of-title rights and financial lease rights as security rights, it is often possible for a seller (although not a lessor) to transfer title to the asset being sold to the buyer and take back a security right. Sometimes these seller's rights arise by operation of law (e.g. the vendor's privilege), but sometimes they arise from an agreement between the seller and the buyer. In such cases, the buyer may well grant competing security rights in the asset being acquired. These rights will usually be security rights granted after the asset has been purchased. Less commonly, in most of these States, they might also arise beforehand, by virtue of a security right covering present and future assets. Nonetheless, even when the lender advances credit to enable a buyer to acquire the assets, the security it takes in those assets is invariably considered to be an ordinary security right. That is, in most States that do not treat retention-of-title rights or financial lease rights as security rights, it is not possible for lenders to directly accede to the preferred priority position that is given to a seller that transfers ownership to a buyer and takes back an acquisition security right. Once again, in most such States, the only way that a lender could acquire the preferred priority afforded to an acquisition security right would be to obtain an assignment of the secured obligation from the seller that has taken such a security right for itself.

176. In States that follow the fully integrated approach, the priority rights of a seller and a lessor are protected because the rights they would otherwise claim as owners are characterized as acquisition security rights and are given the same preferred priority position through the concept of the "purchase-money security interest" special priority. Such a preferred priority position is also afforded to sellers that simply take a security right in the assets being supplied and to lenders that advance money to borrowers so as to enable them to purchase tangible assets. In other words, under the fully integrated approach, it is possible to have a genuine conflict between more than one acquisition security right. The normal priority rule in such States is that, as between competing security rights of the same type, the first to register, or if another method for achieving third-party effectiveness is used the first to achieve third-party effectiveness, would prevail. Thus, for example, as between two lenders that may both claim an acquisition security right, the first to register will have priority. It may be, however, that a seller that claims an acquisition security right registers its notice after a lender that has also provided acquisition financing. In this one case, these systems override the usual priority rule so as to protect the prior owner of the asset being sold. The seller that makes its acquisition security right effective against third parties will have priority even over lenders with pre-existing acquisition security rights.

177. Under the unitary approach, in any competition between a seller that is claiming an acquisition security right and a lender that is also claiming an acquisition security right, the seller's acquisition security right will have priority regardless of the respective dates that these acquisition security rights were made effective against third parties (see recommendation 178). In addition, in a competition between two acquisition security rights taken by lenders, the normal priority rules apply. That is, the time at which the right became effective against third parties will determine the relative priority of the two rights.

178. In States that choose to adopt the non-unitary approach, an initial policy decision is whether to permit financiers other than sellers or lessors to take security rights in assets being acquired by their borrower that can achieve the preferred priority status of an acquisition security right. If not, there will never be a competition between two or more acquisition financiers. The Guide recommends that, even when assets are sold under a retention-of-title arrangement or are subject to a financial lease, the buyer may grant security over the asset being sold or leased (see recommendation 187). Moreover, it also recommends that lenders that provide acquisition financing to buyers be permitted to claim an acquisition security right (see recommendations 184 and 185). As a result, States that adopt the non-unitary approach will also face a possible competition between providers of acquisition financing. Should the competition be between a retention-of-title seller or a financial lessor and a lender, the seller or lessor will always have priority as a consequence of its right of ownership. Should the competition be between a seller that claims an acquisition security right and a lender claiming such a right, States will have to adopt a rule that provides for the priority of the seller's or lessor's acquisition security right, whatever their respective dates of effectiveness against third parties. Moreover, States will also be required to specify that, as between acquisition security taken by financiers other than sellers or lessors, the priority of these rights will be determined by the time they became effective against third parties, regardless of the form of the transaction.

[Note to the Commission: The Commission may wish to consider whether a recommendation along the lines of recommendation 178 (unitary approach) should be included also in the non-unitary approach section of chapter XI.]

(n) Effect of the failure of a provider of acquisition financing to make its acquisition rights effective against third parties

179. Normally, a retention-of-title seller, a financial lessor or a seller or lender that takes a security right in assets being acquired by a buyer will ensure that it has taken all the steps necessary to make its rights effective as against third parties. In the case of a retention-of-title right or a financial lease right this means following one of the methods for achieving third-party effectiveness, and in the case where this is accomplished through registration in the general security rights register, doing so within the indicated time (see recommendation 189). In the case of an acquisition security right, whether under the unitary or non-unitary approach, the secured creditor must take the steps necessary to achieve third-party effectiveness, and if that step is registration in the general security rights registry, doing so within the indicated time (see recommendations 176 and 189).

180. A failure to achieve third-party effectiveness within the applicable time period has significant consequences for all providers of acquisition financing. Should an

acquisition secured creditor fail to register in a timely fashion (see para. 122 above), this does not mean that it loses its security right. Provided that it has taken the steps necessary to achieve third-party effectiveness after the expiry of the grace period, the secured creditor claiming an acquisition security right will not be able to assert the special priority associated with that right. At this point, it will simply be an ordinary secured creditor subject to the general priority rules applicable to security rights.

181. The situation is slightly different where a retention-of-title seller or a financial lessor fails to make its rights effective against third parties in a timely way. In these cases, the seller or lessor loses the benefit of its ownership, and in so far as the rights of third parties are concerned, title to the asset being sold or leased is transferred to the buyer or lessee. The complete loss of rights is a severe consequence to attach to a failure to take the steps necessary to achieve third-party effectiveness. In order to palliate these consequences and to parallel the result reached in respect of acquisition security rights, it is necessary to convert the seller's or lessor's right into an ordinary security right, subject to the general priority rules applicable to security rights (see recommendation 193).

182. A similar conclusion should be reached in other cases where a retention-of-title seller or a financial lessor is deprived of its rights of ownership. For example, where the seller of an asset that becomes an attachment to immovable property is not made effective against third parties after the attachment in a timely way, the seller or lessor loses its ownership right. Once third-party effectiveness is achieved, however, the seller or lessor may claim an ordinary security right.

[Note to the Commission: The Commission may wish to consider whether a recommendation along the lines of recommendation 193 should be added to address the point made in paragraph 182.]

8. Pre-default rights and obligations of the parties

183. As noted in the chapter on the rights and obligations of the parties, in most States there are very few mandatory rules setting out pre-default rights and obligations of the parties. The vast majority of applicable rules and principles are suppletive (non-mandatory) and may be freely derogated from by the parties. In addition, for the most part the pre-default rights and obligations of the parties will depend on how any particular State conceives the legal nature of the transaction by which acquisition financing is provided.

184. In States that do not treat retention-of-title rights and financial lease rights as security rights, the regime governing pre-default rights and obligations applicable to non-acquisition security rights cannot be simply transposed to acquisition financing rights. The rules applicable to acquisition security rights (whether taken by a seller or by a lender) will mirror those applicable to non-acquisition security rights. However, where a title device (retention-of-title, financial lease or similar transaction) is at issue, it will be necessary to adjust the manner by which these rules are expressed.

185. As the objective is to achieve functional equivalence among all acquisition financing transactions, this will often require reversing the default presumptions about the prerogatives of ownership. That is, normally it is the owner (the retention-of-title seller or the financial lessor) that has the right to use an asset and to collect

the civil and natural fruits it produces. Normally it is the owner that bears the risk of loss and, therefore, has the primary obligation to care for the asset, maintain it, keep it in good repair and insure it; and normally, it is the owner that has the right to further encumber the asset and to dispose of it. In order to achieve the desired functionally equivalent results, therefore, these States will have to provide a mix of mandatory and non-mandatory rules vesting each of these prerogatives and these obligations in the buyer and not in the seller or lessor.

186. States that adopt the unitary approach need not attend directly to this issue, since an acquisition security right is simply a species of security right. As such, it would only be necessary to apply the regular rules about pre-default rights and obligations to all acquisition financing transactions, regardless of the form of the transaction in question. That is, there is no reason to assume that obligations relating to use, the obligation to protect the value of the secured assets, the collection of civil and natural fruits, the right to encumber, or the right to dispose should be any different simply because the security right at issue is an acquisition security right. If acquisition secured creditors and grantors wish to provide for a different allocation of rights and obligations, they should be permitted to do so within exactly the same framework as applicable to non-acquisition secured rights (see recommendations 107-110).

187. Should a State adopt the non-unitary approach, however, the specific pre-default rights and obligations of the parties will have to be spelled out in greater detail in order to achieve functional equivalence. In relation to retention-of-title sellers and financial lessors, these rules will often have to be enacted as exceptions to the regular regime of ownership rights. As noted in the chapter on the rights and obligations of the parties, most of the pre-default rules will not be mandatory. However, as the non-mandatory default regime should establish a set of terms about pre-default rights and obligations that the legislature believes the parties would choose to most efficiently achieve the purpose of a security device, States that do adopt the non-unitary approach should ensure the enactment of non-mandatory rules that mirror those it enacts to govern acquisition security rights taken by sellers or lenders. So doing would have the additional advantage of clearly specifying the right of the buyer to grant security over its expectancy right, and confirming the buyer's right to use, transform or process the assets in a reasonable manner consistent with its nature and purpose (see recommendations 107-110).

9. Enforcement

188. The discussion in the chapter on the enforcement of a security right illustrates that in most legal systems the rules relating to enforcement of post-default rights flow directly from the manner in which that legal system characterizes the substantive right in question. For example, many systems consider certain rights to be "property rights" and provide for special remedies to ensure their effective enforcement. Other rights are characterized as "personal rights" and are usually enforced by bringing an ordinary legal action against a person. In such systems, both the right of ownership and security rights in tangible assets are seen as a species of "property right" enforceable through an *in rem* action (an "action against the asset"). Although the specifics of enforcement of property rights through *in rem* actions can vary greatly depending on the particular property right enforced and the specific configuration of a State's procedural laws, for the most part these rules

governing enforcement of post-default rights are mandatory. As such, they cannot be derogated from by the parties to an acquisition financing transaction.

189. In States that do not treat retention-of-title rights and financial lease rights as security rights, the procedure for enforcement of the seller's or the lessor's rights will normally be that open to any person that claims ownership in tangible assets. So, for example, upon default by the buyer, the retention-of-title seller may terminate the sale agreement and demand return of the assets as an owner. In that event and subject to any term of the agreement to the contrary, the seller is normally also required to refund at least a part of the price paid by the buyer. The amount of the payment due by the seller is often calculated by requiring disgorgement of all money received from the buyer, minus the rental value of the asset while in the possession of the buyer and the amount by which the value of the asset has decreased as a result of its use by the buyer (or damages for depreciation determined under a similar formula).

190. In these States, a seller that terminates the sale is usually not obliged to account to the buyer for any of the profits made on any subsequent resale of the asset but, at the same time, unless otherwise provided by contract, the seller has no claim against the buyer for any deficiency beyond any direct damages resulting from the buyer's breach of the original sales contract. In some legal systems, courts have also ruled in certain instances that there is an implied term in retention-of-title arrangements that the seller cannot repossess more of the assets sold than is necessary to repay the outstanding balance of the purchase price. Finally, in most of these States, neither the defaulting buyer nor any third party, such as a judgement creditor or a creditor that has taken security on the expectancy right of the buyer in the asset being reclaimed by the seller, may require the seller to abandon its right to recover the assets. As the seller is and always has been the owner of the assets being reclaimed, it cannot be compelled to sell those assets as if it were simply an acquisition secured creditor enforcing an acquisition security right. The only recourses of judgement creditors, secured creditors and other acquisition secured creditors are: (a) if the seller or lessor agrees, to purchase the rights of the seller or lessor (becoming subrogated into the seller's or lessor's rights); or (b) to pay whatever is outstanding under the contract and then exercise their rights on the assets that, as a result, are thereafter owned by the buyer or lessee.

191. The position of a seller that reclaims ownership and possession of assets under a proviso that, having transferred ownership to the buyer, it may retroactively set aside the sale should the buyer not pay the purchase price as agreed (a resolutive condition) is similar to that of the retention-of-title seller. Upon default, the sale is terminated, and the seller reacquires ownership. It may then reclaim possession of the assets as the owner subject to disgorging to the buyer whatever has been paid (discounted in the manner already indicated). In other words, once the resolutive condition takes effect, the rights and obligations of the seller that regains ownership are identical to those of the retention-of-title seller.

192. The situation of the financial lessor is normally slightly different. Since a lease is a contract of continuing performance (the lessee has continuing possession and use while the lessor has a continuing right to payment of the rent), under most legal systems, the lease contract will be terminated for the future only. This result means that the lessee will lose the right to purchase the assets at the end of the lease (or to automatically acquire ownership if the contract so provides), that the lessor will

keep the full rental payments received and that the lessee will be obliged to return the assets to the lessor. Subject to any contrary provision in the lease agreement, however, the financial lessor will not be able to claim damages for the normal depreciation of the assets. Damages will be claimable only for waste or extraordinary depreciation. Moreover, unless the lease agreement provides otherwise, financial lessors will not usually be able to claim any shortfall between the amount they receive as rent and the depreciation of the leased assets.

193. Under the unitary approach, the acquisition secured creditor may repossess the assets, as would any other secured creditor. Whether the acquisition secured creditor is a seller, lessor or lender, it will be able, as outlined in the chapter on the enforcement of a security right, either to sell the assets, or if the grantor or other secured creditor do not object, to take the assets in satisfaction of the secured obligation. In the former case, the enforcing creditor will be able to sell under judicial process or privately. Having sold the assets, the secured creditor then has to return to the grantor any surplus on the resale of the assets, but concomitantly has an unsecured claim for any deficiency after the sale (see recommendation 174).

194. If a State adopts the non-unitary approach, several adjustments to existing rules relating to the enforcement of the ownership right of a retention-of-title seller or a financial lessor would have to be made in order to achieve equality of treatment among all providers of acquisition financing. These adjustments could include, for example, giving the buyer or lessee and any secured creditor with a right in the buyer's or lessor's expectancy right, the right to compel a seller or lessor to sell the assets in which ostensibly it has a right of ownership, rather than simply assert that ownership right to regain possession of and ultimately to dispose of the assets. Sellers and lenders with acquisition security rights may propose to take the assets in satisfaction of the buyer's outstanding obligation, but the buyer or other interested party may compel the acquisition secured creditor to sell the assets instead. Achieving full functional equivalence would mean that buyers and other interested parties would be enabled to compel the retention-of-title seller (an owner) to abandon the assertion of its right of ownership and to sell the assets as if it were simply an acquisition secured creditor. It would also require adjusting the seller's or lessor's rights so that they would be required to account for a surplus upon any sale in disposition, while at the same time permitting them to recover as simple contractual claimants for a deficiency without having to bring a separate action in damages.

195. Deficiencies are much more common than surpluses. Still, requiring all providers of acquisition financing (including retention-of-title sellers and financial lessors) to account to the buyer and other creditors with security rights in the expectation right of the buyer for any surplus upon enforcement will encourage those other creditors to monitor the enforcement process closely and thereby enhance the chances that the highest possible value will be achieved. Likewise, providing the provider of acquisition financing with a deficiency claim allows the creditor to enforce its full claim, which enhances the likelihood of complete repayment. A rule that would deny, absent a contractual term for damages, a deficiency claim to certain providers of acquisition financing (notably retention-of-title sellers or financial lessors), when such a deficiency claim would be enforceable by a seller or lender that exercised an acquisition security right, would be unfair and inefficient. The rights of a seller, especially, should not be significantly different

(either to the seller's advantage or to its disadvantage), depending only on whether it chose to retain title or to take an acquisition security right.

196. As a matter of strict legal logic, it is possible to achieve functionally equivalent enforcement results regardless of whether a unitary or a non-unitary approach is adopted. The need for these several adjustments to existing retention-of-title and financial-lease regimes in order to achieve the full benefit of treating all sources of acquisition financing equally, as recommended in the Guide (see recommendation 197), suggests that it may be preferable for States that have not already achieved this coordinated result through legislative, judicial or contractual adjustments to their rules governing retention-of-title rights and financial lease rights to do so by adopting the unitary approach. Nonetheless, the non-unitary approach will, if implemented as recommended in the Guide (see recommendation 197), produce an efficient enforcement regime for acquisition financing transactions.

10. Conflict of laws

197. Many legal systems differentiate between rights of ownership arising under a contract of sale or lease and security rights in presenting rules relating to the applicable law. That is, conflict-of-laws rules relating to obligations (for example, not only sales and leases, but also licences and receivables) may differ from those applicable to agreements creating a security right in tangible assets. The treatment of conflicts of laws in relation to security rights in general, and accompanying recommendations, are included in the chapter on conflict of laws. The present discussion only addresses whether retention-of-title rights, financial lease rights and acquisition security rights should be the subject of different recommendations.

198. Notwithstanding the conceptual differences between rights that flow from ownership and security rights, when a retention-of-title right is being used to secure the performance of a payment obligation and possession has been delivered to the buyer, the appearance of the transaction is no different from that where a non-possessory security right is created. Moreover, the asset in question is equally mobile, and is consequently equally likely to cross international borders. As the Guide recommends that lenders may acquire not only security rights, but also acquisition security rights in the expectancy of a buyer, it is possible that once an asset crosses a border and unless the same conflict-of-laws rules are applicable to all such rights, different laws will govern the retention-of-title right and the acquisition security right. Efficiency and transparency of transactions would suggest that this type of conflict should be avoided if at all possible, and that the same conflict-of-laws rules should govern both types of transaction.

199. Under the unitary approach, whether an acquisition financing transaction involves a retention-of-title right, a financial lease right or an acquisition security right is immaterial for conflict-of-laws purposes. All will be considered as security rights and dealt with accordingly (see recommendation 174).

200. Should a State decide to retain the non-unitary approach, however, it will face the question of whether the conflict-of-laws rules applicable to the creation, third-party effectiveness, priority and enforcement of retention-of-title rights, financial lease rights and similar arrangements should be the same as those that apply to acquisition security rights or, more generally, to ordinary security rights

that are taken in the same type of asset. The goal of achieving functionally equivalent outcomes is a powerful argument that States should characterize the ownership rights of retention-of-title sellers and financial lessors as equivalent to acquisition security rights for conflict of laws purposes (see recommendation 199).

11. Transition

201. The rules recommended in the Guide relating to the treatment of transactions that in many States were not considered to be security devices represent a significant change for most legal systems. In particular, the characterization of retention-of-title rights and financial lease rights (including rights under hire-purchase agreements) as acquisition security rights will bring about an important modification to the scope of secured transactions law in legal systems that have not already adopted the unitary and functional approach to secured transactions generally. The chapter on transition discusses principles that should govern the transition to the new regime for ordinary security rights as recommended in the Guide. These same principles should regulate the transition in relation to acquisition financing transactions.

202. If a State were to adopt the unitary approach, a smooth transition will depend on attending to the detail of the previous regime governing retention-of-title rights and financial lease rights. For example, if it were already obligatory for retention-of-title sellers and financial lessors to register their rights, then it would only be necessary to provide for a certain delay within which the registration would have to be renewed in the new general security rights registry. Alternatively, the law could provide that the existing registration would remain effective for a sufficiently long time period (e.g. three to five years) to cover the life span of most retention-of-title or financial lease arrangements (see recommendation 228).

203. If no registration of these rights were currently necessary, a smooth transition could be achieved if, consistent with the transition rules applicable to non-acquisition financing transactions, the effectiveness of the rights of retention-of-title sellers and finance lessors against third parties and their priority position were capable of being preserved by registering an appropriate notice in the general security rights registry. Alternatively, the law could provide that the registration requirement would take effect at a date sufficiently far in the future after the new law comes into force (e.g. three to five years) so that it would cover the life span of most retention-of-title and financial lease arrangements existing at the time the new law came into force (see recommendation 228). In order to ensure coherence of the transition, and consistent with the approach taken in the chapter on transition, whatever the length of the transition period that is adopted, it should be the same for rights that had to be registered under prior law, for rights that were exempt from registration under prior law and for non-acquisition security rights.

204. Even if a State decides to adopt the non-unitary approach, in order to establish an efficient secured transactions law, it will be necessary to reorder a number of rules relating to retention-of-title rights and financial lease rights. As the Guide recommends that a notice be registered in the general security rights registry, the same transition rules for registration applicable to the unitary approach could be adapted for the non-unitary approach. As for existing acquisition security rights, the transition should be governed by the same principles as apply to the transition under the unitary approach.

205. In order to put these principles into operation in a manner that produces outcomes that are functionally equivalent to those achieved under the unitary approach, however, various adjustments to the substance of the law relating to retention-of-title rights and financial lease rights would be required. In particular, it would be necessary to determine when the rules relating to the following issues will come into effect: (a) the priority of acquisition financing rights in proceeds; (b) the rights of third parties to acquire security rights in assets subject to a retention-of-title right or a financial lease right; and (c) the procedures for enforcing these types of acquisition financing device including the rights of third parties. While the scale and scope of the needed transition under the non-unitary approach initially might not appear to be as great, the issues that arise in practice will be identical to those arising under the unitary approach and the general principles governing adoption of a unitary regime should also apply to the transition to a reformed non-unitary regime.

12. Insolvency

206. One of the central themes of the Guide is that a security right has little or no value to a secured creditor unless it is given appropriate recognition in insolvency proceedings of the grantor. Thus, an effective secured transactions regime must go hand-in-hand with an effective insolvency law. Both are essential to promoting secured credit. For this reason, this Guide goes hand-in-hand with its companion guide, the *UNCITRAL Legislative Guide on Insolvency Law* (“the *UNCITRAL Insolvency Guide*”).

207. The general interaction of insolvency law and secured transactions law is addressed in the chapter on the impact of insolvency on a security right. The Guide’s recommendations on this topic are in two parts: part A, which reproduces those recommendations of the *UNCITRAL Insolvency Guide* that have a direct bearing on secured transactions, and part B, which is comprised of additional recommendations that are intended to supplement those of the *UNCITRAL Insolvency Guide*. The *UNCITRAL Insolvency Guide* generally defers to non-insolvency law (e.g. a State’s secured transactions law) with respect to how a particular acquisition financing transaction is characterized and the legal implications of that characterization.

208. The principle that insolvency law generally defers to non-insolvency law on matters of characterization means that, in States that integrate all forms of acquisition financing rights into their secured transactions law, retention-of-title transactions and financial leases will be treated in the grantor’s insolvency in the same way as a non-acquisition security right, with recognition given to any special priority status accorded to the acquisition security right under non-insolvency law. Accordingly, the provisions of the *UNCITRAL Insolvency Guide* applicable to security rights would apply to acquisition security rights. Thus, if a State were to adopt the unitary approach, this means that the insolvency law should treat assets subject to an acquisition security right in the same way as assets subject to security rights generally (recommendation 183).

209. A slightly more complicated analysis is required in States that do not treat retention-of-title transactions and financial leases as security devices. Some of these States maintain separately denominated retention-of-title transactions and financial leases but subject them and similar arrangements to the same rules that apply to

non-acquisition security rights, with recognition given to any special priority status accorded to the acquisition security right under non-insolvency law. That is, in these States the ownership of retention-of-title sellers and financial lessors is converted by secured transactions law into a security right when the grantor becomes insolvent. Consequently, the same outcome in insolvency is reached as is achieved in States with fully integrated regimes. Accordingly, the provisions of the *UNCITRAL Insolvency Guide* applicable to security rights will then apply to these transactions, even though under non-insolvency law, they would not be characterized as security rights (recommendation 198, alternative A).

210. Other States that maintain separately denominated retention-of-title transactions and financial leases nonetheless provide for a rough functional equivalence between these rights and acquisition security rights. In these States, retention-of-title transactions and financial leases are treated as assets owned by the seller or lessor. Accordingly, the provisions of the *UNCITRAL Insolvency Guide* relating to third-party-owned assets would then apply to these transactions (see recommendation 198, alternative B).

211. These alternatives can have very different results in insolvency proceedings, especially where reorganization is a possibility. In States that integrate all forms of acquisition financing rights into their secured transactions law, retention-of-title transactions and financial leases are treated in the grantor's insolvency in the same way as a non-acquisition security right, with recognition given to any special priority status accorded to the acquisition security right under non-insolvency law. In these States, typically the insolvency representative can use, sell or lease the encumbered assets so long as it gives substitute assets to the secured creditor or the value of the secured creditor's right in the property is otherwise protected against diminution. In such situations, any portion of the secured obligations in excess of the value of the secured creditor's right in the property is treated as a general unsecured claim, and in the grantor's reorganization the secured creditor's claim, up to the value of the security right, can be restructured (as is the case with other non-acquisition security rights) with a different maturity, payment schedule, interest rate and the like (see chapter on the impact of insolvency on a security right, paras. [...]).

212. The above-mentioned discussion illustrates that in States where retention-of-title transactions and financial leases are not treated as security rights, the insolvency representative often has the right, within a prescribed time period and if willing and able to do so, to perform the contract by: (a) paying the outstanding balance of the price and bringing the property into the estate; or (b) continuing to pay the lease payments as they come due. In some cases, the insolvency representative can assign the contract, together with the right to use the property (which in the case of a lease may require the consent of the lessor) to a third party. Alternatively, the insolvency representative may be able to reject the contract, return the property and claim the return of the part of the purchase price paid by the buyer subject to a deduction for depreciation and use prior to the insolvency. In the case of a lease, the insolvency representative can repudiate the lease for the future and return the property to the lessor. However, if the property is critical to the success of the buyer's reorganization, only the first option (performance of the contract as agreed) would in practice be available to the insolvency representative. The need for the insolvency representative to perform the contract as agreed may, for example in

cases where the current value of equipment is less than the balance of the purchase price, result in other assets of the insolvency estate being used to satisfy that performance rather than being used to fund other aspects of the reorganization of the grantor.

213. In States where assets subject to retention-of-title rights and financial lease rights are treated as third-party-owned assets, the retention-of-title seller and the financial lessor will have stronger rights at the expense of other creditors of the insolvency proceedings. This inevitably will have an impact on the capacity of the insolvency representative to pursue reorganization. As a consequence, States that adopt the non-unitary approach to acquisition financing in non-insolvency situations must also consider whether this characterization of retention-of-title rights, financial lease rights and similar rights should be maintained in insolvency proceedings. The legislative choice is whether encouraging the supply and financing of equipment or inventory by providing special rights for retention-of-title sellers and financial lessors should outweigh insolvency policies that seek to promote reorganization.

B. Recommendations

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

A/CN.9/637/Add.6 [Original: English]

**Note by the Secretariat on terminology recommendations of the UNCITRAL draft
Legislative Guide on Secured Transactions, submitted to the Working Group on
Security Interests at its twelfth session**

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XII. Conflict of laws

A. General remarks

1. Introduction

(a) Purpose of conflict-of-laws rules

1. The central purpose of the Guide is to assist States in the development of modern secured transactions laws with a view to promoting the availability of secured credit, thus promoting the growth of domestic businesses and generally increasing trade (see para. [...]). In order to achieve this purpose, a secured transactions law has to facilitate credit both from domestic and foreign lenders and from other credit providers, promoting the growth of domestic businesses and generally increasing trade. Much of secured transactions law is meant to deal with grantors, secured creditors, third-party obligors and third-party creditors that are all located in the same State. It is also directed to security agreements covering encumbered assets also located in this same State, both at the time the security right is created and at all times thereafter. However, a significant part of modern commercial activity is not of this type. Increasingly, secured transactions law involves agreements between or affecting parties located in more than one State, or relating to assets that are meant for export or import, or are located in more than one State, or that are normally used in more than one State. Necessarily, therefore, to achieve comprehensiveness the Guide must address a broad range of issues that arise from various types of cross-border transaction.

2. This chapter discusses the rules for determining the law applicable to the creation, effectiveness against third parties (“third-party effectiveness”), priority as against the rights of competing claimants and enforcement of a security right (for the definitions of the terms “security right”, “priority” and “competing claimant”, see Introduction, section B, Terminology). These rules, generally referred to as conflict-of-laws rules, also determine the territorial scope of the substantive rules envisaged in the Guide (i.e. if and when the substantive rules of the State enacting the regime envisaged in the Guide apply). For example, if a State has enacted the substantive law rules envisaged in the Guide relating to the priority of a

security right, those rules will apply to a priority contest arising in the enacting State only to the extent that the forum¹ State's conflict-of-laws rule on priority issues points to the laws of that State. Should the forum State's conflict-of-laws rule provide that the law governing priority is that of another State, then the relative priority of competing claimants will be determined in accordance with the law of that other State.

3. The conflict-of-laws rules proposed in the Guide will apply only if the forum State is a State that has enacted the rules recommended by the Guide. They cannot apply in a State that has not enacted those rules. This is so because a State cannot legislate on the conflict-of-laws rules to be applied in another State. The courts of the other State apply their own conflict-of-laws rules in order to determine whether to apply their domestic substantive law or the substantive law of another State.

4. The conflict-of-laws rules indicate the State whose substantive law will apply to a situation by identifying the factors that connect the situation to that State. The main connecting factors recommended by the Guide are the location of the encumbered assets and the location of the grantor of the security right. Thus, in a situation where the connecting factor is the location of the assets, the law applicable will be that of the State of the location of the assets.

5. After a security right has been created and has become effective against third parties, a change might occur in one or more connecting factors. For example, if the third-party effectiveness of a security right in inventory located in State A is governed under the conflict-of-laws rules of State A by the law of the location of the inventory, the question arises as to what happens if part of the inventory is subsequently moved to State B (whose conflict-of-laws rules also provide that the law of the location of tangible assets governs the third-party effectiveness of security rights in tangible assets). One approach would be for the security right to continue to be effective in State B without the need to take any further step in State B. Another approach would be to require that a new security right be obtained under the laws of State B. Yet another approach would be for the secured creditor's pre-existing right to be preserved subject to the fulfilment in State B of certain formalities within a certain period of time (e.g. 30 days after the goods have been brought into State B). As this is a matter of substantive law rather than conflict of laws, the Guide addresses it in chapter V dealing with third-party effectiveness (see paras. [...] and recommendation 45). This chapter deals only with the time that is relevant for the determination of whether a security right has been created, made effective against third parties and obtained priority over another right.

6. In an efficient secured transactions regime, conflict-of-laws rules applicable to secured transactions normally reflect the objectives of the secured transactions regime. This means that the law applicable to the property aspects of a security right should be easy to determine. Certainty is a key objective in the development of rules affecting secured transactions both at the substantive and the conflict-of-laws levels. Another objective is predictability. As illustrated by the example mentioned in the preceding paragraph, conflict-of-laws rules should provide an answer to the

¹ The term "forum State" refers to the State in respect of which one has to ascertain the substantive law to apply in that State. Ascertaining the applicable law is necessary not only in a litigation context but also in every instance where there is a need to know if a transaction will provide its intended legal effects.

question of whether a security right acquired under the law of State A remains subject to that law or becomes subject to the law of State B if a subsequent change in the connecting factor were to point to the law of State B for a security right of the same type. A third key objective of an efficient conflict-of-laws system is that the relevant rules should reflect the reasonable expectations of interested parties (i.e. creditor, grantor, debtor and third parties). In order to achieve this result, the connecting factor that indicates the law applicable to a security right must have some real relation to the factual situation that will be governed by such law.

7. Use of the Guide (including this chapter) in developing secured transactions laws will help to reduce the risks and costs resulting from divergences among current conflict-of-laws regimes. In a secured transaction, the secured creditor normally wants to ensure that its rights will be recognized in all States where enforcement might take place (including in a jurisdiction administering insolvency proceedings with respect to the grantor and its assets). If those States have different conflict-of-laws rules for the same type of encumbered asset, the creditor will need to comply with more than one regime in order to be fully protected (a result that is likely to affect the availability and the cost of credit). A benefit of different States having harmonized their conflict-of-laws rules is that a creditor can rely on the same conflict-of-laws rule (leading to the same results) to determine the status of its security in all those States. This is one of the goals achieved in respect of receivables by the United Nations Assignment Convention and in respect of indirectly held securities by the Convention on the Law Applicable to Certain Rights in respect of Securities held with an Intermediary, adopted by the Hague Conference on Private International Law in December 2002 (hereinafter referred to as “the Hague Securities Convention”).

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

(b) Scope of conflict-of-laws rules

9. This chapter does not define the security rights to which the conflict-of-laws rules will apply. Normally, the characterization of a right as a security right for conflict-of-laws purposes will reflect the substantive secured transactions law in a State. In principle, a court will use its own law whenever it is required to characterize an issue for the purpose of selecting the appropriate conflict-of-laws rule. The question arises, however, as to whether the conflict-of-laws rules of a State relating to security rights should also apply to other transactions that are functionally similar to security rights, even if they are not covered by the substantive secured transactions regime of that State (e.g. retention-of-title sales, financial leases and other similar transactions). The fact that the substantive secured transactions law of a State might not apply to those other transactions should not preclude the State from applying to those transactions the conflict-of-laws rules applicable to security rights. The Guide recommends this approach to a State that would adopt the non-unitary approach to acquisition financing (see recommendation 199).

10. A similar issue arises in respect of certain transfers not made for security purposes, where it is desirable that the applicable law for creation, third-party effectiveness and priority of the transfer be the same as for a security right in the same type of asset. An example is found in the United Nations Assignment Convention, which (including its conflict-of-laws rules) applies to outright transfers of receivables as well as to security rights in receivables (see article 2, subparagraph (a) of the Convention). This policy choice is motivated, notably, by the necessity of referring to one single law to determine priority between competing claimants with a right in the same receivable. The Guide adopts the same policy (see recommendation 205). Otherwise, in the event of a priority dispute between a purchaser of a receivable and a creditor with a security right in the same receivable, it would be more difficult (and sometimes impossible) to determine who is entitled to priority if the priority of the purchaser were governed by the law of State A but the priority of the secured creditor were governed by the law of State B.

11. Whatever decision a State makes with respect to the range of transactions covered by the conflict-of-laws rules, the scope of those rules on creation, third-party effectiveness and priority of a security right will be confined to the property aspects of the relevant transactions. Thus, a rule on the law applicable to the creation of a security right only determines what law governs the requirements to be met for a property right to be created in the encumbered assets. The rule would not apply to the personal obligations of the parties under their contract. In most States, purely contractual obligations arising from a commercial transaction are generally subject to the law chosen by the parties in their security agreement or, in the absence of such a choice, by the law governing the security agreement as determined by the conflict-of-laws rules of the relevant State (e.g. the Convention on the Law Applicable to Contractual Obligations,² concluded in Rome in 1980, hereinafter the “Rome Convention”). The Guide recommends the same approach for the determination of the mutual rights and obligations of the grantor and the secured creditor with respect to the security right (see recommendation 213).

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

13. The conflict-of-laws rules of many States now provide that reference to the law of another State as the law governing an issue refers to the law applicable in that State other than its conflict rules. The doctrine of *renvoi* is excluded, for the sake of predictability and also because *renvoi* may lead to results that run contrary to the expectations of the parties. The Guide adopts the same approach (see recommendation 218).

² United Nations, *Treaty Series*, vol. 1605, No. 28023.

(c) Outline of this chapter

14. This chapter discusses, in section A.2, the conflict-of-laws rules for the creation, third-party effectiveness and priority of a security right in general. Section A.3 reviews the law applicable to the creation, third-party effectiveness and priority of a security right in tangible assets, while section A.4 elaborates the law applicable to the creation, third-party effectiveness and priority of a security right in intangible assets and section A.5 discusses the law applicable to the creation, third-party effectiveness and priority of a security right in proceeds. The chapter then considers, in section A.6, the law applicable to the rights and obligations of the parties to the security agreement, and in section A.7, the law applicable to the rights and obligations of third-party obligors. The law applicable to the enforcement of a security right is commented on in section A.8. The last three sections of the chapter deal with the rules and relevant time for the determination of location (section A.9), public policy and internally mandatory rules (section A.10) and special rules when the applicable law is the law of a multi-unit State (section A.11). The chapter concludes, in section B, with a series of recommendations.

2. Conflict-of-laws rules for the creation, third-party effectiveness and priority of a security right

15. The determination of the extent of the rights conferred by a security right generally requires a three-step analysis, as follows:

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

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

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

16. Indeed, a security right is of little practical value if it cannot be efficiently enforced. This question does not, however, relate to the extent of the rights that the secured creditor has in the encumbered assets, and the conflict-of-laws rules on enforcement will be discussed in another section of this chapter.

17. Not all States draw a distinction between the three issues mentioned in paragraph 15. In many States, a security right (or other property right) once created is by definition effective against all (*erga omnes*) without any further action. In those States, the same conflict rule applies to the creation of a security right and its effectiveness against third parties (and priority may be analysed also as an issue of effectiveness). However, even States that clearly distinguish among effectiveness as between the parties (creation), effectiveness against third parties and priority do not always establish a separate conflict-of-laws rule for each of those issues; thus the same conflict-of-laws rule may apply to each of the three issues resulting in the substantive law of the same State being applicable to all such issues.

18. Therefore, the key question is whether one single conflict-of-laws rule should apply to all three issues. Policy considerations, such as simplicity and certainty,

favour the application of only one rule. As noted above, the distinction among these issues is not always made or understood in the same manner in all States, with the result that providing different conflict-of-laws rules on these issues may complicate the analysis or give rise to uncertainty. There are, however, instances where selecting a different law for priority issues would better take into account the interests of third parties such as persons holding statutory security or a judgement creditor or an insolvency administrator.

19. Another important question is whether, on any given issue (i.e. creation, third-party effectiveness or priority), the relevant conflict-of-laws rule should be the same for tangible and intangible assets. A positive answer to that question would favour either a rule based on the law of the location of the grantor or a rule based on the law of the location of the encumbered assets (*lex situs* or *lex rei sitae*).

20. In the case of receivables, an approach based on the *lex situs* would be inconsistent with the United Nations Assignment Convention (article 22 of which refers to the law of the State in which the assignor, i.e. the grantor, is located). Moreover, as intangible assets are not capable of physical possession, adopting the *lex situs* as the applicable conflict-of-laws rule would require the development of special rules and legal fictions for the determination of the actual location of various types of intangible asset. For this reason, the Guide does not consider the location of the asset as being the appropriate connecting factor for intangible assets and favours an approach generally based on the law of the location of the grantor (see recommendation 205).

21. In addition, consistency with the United Nations Assignment Convention would dictate defining the location of the grantor in the same way as in the Convention (see recommendation 216). Under the Convention, the grantor's location is its place of business or, if the grantor has places of business in more than one State, the place where the central administration of the grantor is exercised. If the grantor has no place of business, reference is then made to the grantor's habitual residence (see article 5, subparagraph (h), of the Convention). This definition was adopted by the Convention mainly because that location was considered as being the real location of the grantor and also leads to the law of the State in which the main insolvency proceedings with respect to the grantor will most likely be opened.

22. Simplicity and certainty considerations could even support the adoption of the same conflict-of-laws rule (e.g. the law of the grantor's location) not only for intangible assets but also for tangible assets, especially if the same law were to apply to the creation, third-party effectiveness and priority of a security right. Following this approach, one single enquiry would suffice to ascertain the extent of the security rights encumbering all assets of a grantor. There would also be no need for guidance in the event of a change in the location of encumbered assets or to distinguish between the law applicable to possessory and non-possessory rights (and to determine which prevails in a case where a possessory security right governed by the law of State A competes with a non-possessory security right in the same assets governed by the law of State B).

23. Not all States, however, regard the law of the location of the grantor as sufficiently connected to security rights in tangible assets, at least for "non-mobile" assets (or even in certain types of intangible asset, such as rights to payment of funds credited to a bank account or intellectual property). Moreover, in many cases,

adoption of the grantor's location law would result in one law governing a secured transaction and another law governing a transfer of ownership in the same assets. To avoid this result, States would need to adopt the grantor's location law for all transfers of ownership.

24. In addition, it is almost universally accepted that a possessory security right should be governed by the law of the place where the assets are held, so that adopting the law of the grantor for possessory rights would run against the reasonable expectations of non-sophisticated creditors. Accordingly, even if the law of the grantor's location were to be the general rule, an exception would need to be made for possessory security rights.

25. For all these reasons, the Guide recommends two general conflict-of-laws rules on the law applicable to the creation, third-party effectiveness and priority of a security right, as follows:

(a) With respect to tangible assets, the applicable law should be the law of the location of the assets (see recommendation 200);

(b) With respect to intangible assets, the applicable law should be the law of the location of the grantor (see recommendation 205).

26. As the conflict-of-laws rules generally will be different depending on the tangible or intangible character of the assets, the question arises as to which conflict rule is appropriate where intangible assets are capable of being the subject of a possessory security right. In this regard, most States assimilate certain categories of rights embodied in a document (such as a negotiable instrument) to tangible assets, thereby recognizing that a possessory security right may be created in such assets through the delivery of the document to the creditor. The Guide treats these types of intangible assets as tangible assets (for the definition of "tangible assets", see Introduction, section B, Terminology) and, accordingly, the conflict-of-laws rule for tangible assets generally applies to such intangible assets. Accordingly, the law of the State where the instrument is held will govern the creation, third-party effectiveness and priority of a security right in a negotiable instrument (see recommendation 200).

27. A related issue arises where tangible assets are represented by a negotiable document of title (such as a bill of lading). It is generally accepted that a negotiable document of title is also assimilated to a tangible asset and may be the subject of a possessory security right. The law of the location of the document (and not of the actual tangible assets covered thereby) would then govern the security right. The question arises, however, as to what law would apply to resolve a priority contest between a creditor with a security right in a document of title and another creditor to whom the debtor might have granted a non-possessory security right in the tangible assets themselves, if the document and the tangible assets are not held in the same State. In such a case, the conflict-of-laws rules should accord precedence to the law governing the security right in the document, on the basis that this solution would better reflect the legitimate expectations of interested parties (see recommendation 203). This result would also be consistent with the substantive law rules proposed by the Guide on creation, third-party effectiveness and priority (see recommendations 28, 52 and 105).

3. Law applicable to the creation, third-party effectiveness and priority of a security right in tangible assets

28. The policy considerations favouring the general conflict-of-laws rules set out above do not necessarily apply in all circumstances and other rules apply with respect to certain specified types of asset for which the location of the asset or of the grantor is not the most appropriate connecting factor. In addition, for efficiency purposes, alternative rules apply with respect to assets in transit and assets intended for export. Such assets are not intended to remain in their initial location and may cross the borders of several States before reaching their ultimate destination. The following paragraphs explain the two general conflict-of-laws rules outlined above and their exceptions.

(a) General rule: law of the location of the encumbered asset (*lex situs* or *lex rei sitae*)

29. As mentioned above, the creation, the effectiveness against third parties and the priority of a security right in tangible assets are generally governed by the law of the State in which the encumbered asset is located (see recommendation 200). A frequent example of the application of this rule relates to security rights in inventory. If a grantor owns inventory located in a State that has this rule (State A), the law of that State will govern those issues. The rule also means that, if the grantor also owns other inventory in another State (State B), the relevant requirements of State B will have to be fulfilled in order for the courts of State A to recognize that the inventory located in State B is subject to the secured creditor's rights.

30. The general conflict-of-laws rule for tangible assets does not distinguish between possessory security rights and non-possessory security rights. Accordingly, the law of the location of the asset will generally apply, whether or not the secured creditor has possession of the asset. This is particularly relevant for intangible assets assimilated to tangible assets, such as negotiable instruments and negotiable documents. For example, the law of the location of the instrument or document will govern priority matters even if the security right is made effective against third parties otherwise than by possession.

(b) Additional rule for the creation and third-party effectiveness of a security right in goods in transit and export goods

31. With respect to assets in transit or assets intended for export, application of the law of the location of the goods results in the application of the law of the State in which the assets are located at the time an issue arises. A consequence of the rule is that secured creditors need to monitor the assets and follow the requirements of various States to ensure that they have at all times an effective security right. To avoid that burden, one approach would be for the State of the ultimate (or intermediate) destination to recognize as effective a security right created and made effective against third parties under the law of the initial location. Such an approach would reflect the expectations of parties in the initial location of the assets, but would be contrary to the expectations of parties that provided credit to the grantor following the requirements of the law of the ultimate destination of the assets.

32. Another approach would be for the State of the ultimate destination to recognize for a limited period of time a security right created and made effective against third parties under the law of the initial location of the assets. Parties in the initial location could then have a period of time to follow the third-party effectiveness requirements of the law of the State of the ultimate destination to preserve the effectiveness originally acquired in the initial location. Such an approach would balance the interests of parties in the various jurisdictions (and is in fact supported by the Guide for most types of tangible asset; see recommendations 45 and 200).

33. A further approach would be to offer to the secured creditor the option of creating and making its security right effective against third parties under the law of the State of the initial location of the assets or under the law of the State of the ultimate location of the assets provided in the latter case that the assets reach such location within a specified period of time (see recommendation 204). This approach would allow a secured creditor that is confident that the assets will reach the place of their intended destination to rely on the law of that place to create and make its security right effective against third parties. A rule providing for that option is particularly useful when the assets are likely to quickly transit through other States and arrive at their final destination within a short period of time after shipment. Otherwise, in the case of a security right created while the assets are at their initial location, for the security right to be continuously effective against third parties, the secured creditor would have to fulfil the third-party effectiveness requirements of the place of the initial location, of each State where the assets could be in transit and of the place of ultimate destination. In any case, priority would always be subject to the law of the location of the assets at the time a priority dispute arises.

(c) Special rule for the creation, third-party effectiveness and priority of a security right in a negotiable instrument

34. As mentioned above, it is generally accepted that the law of the State in which a negotiable instrument is located (*lex situs*) should govern the creation, third-party effectiveness and priority of a security right in the instrument (see recommendation 200). However, in some States, the third-party effectiveness of a security right in negotiable instruments may also be achieved by registration in the place in which the grantor is located. In such a case, it is logical to rely on the law of the State of the grantor's location to determine whether third-party effectiveness has been achieved by registration (see recommendation 208). It is worth noting that this option is confined to third-party effectiveness. The law of the actual location of the instrument will always govern the priority of a security right in the instrument.

(d) Exceptions for certain types of asset

35. The general conflict-of-laws rule for security rights in tangible assets is normally subject to certain exceptions where the location of the assets would not be an efficient connecting factor (e.g. assets ordinarily used in several States) or would not correspond to the reasonable expectations of the parties (e.g. assets the ownership of which must be recorded in special registries).

(i) Mobile assets

36. Mobile assets are assets that in the normal course of business cross the borders of States (e.g. aircraft, ships or, in some cases, machinery or motor vehicles). For example, a grantor operating a construction business in several States may have to create security rights in machinery periodically moved from one State to another for the purposes of that business; or a grantor operating a transportation business may need to create security rights in the vehicles used in the transportation business (although motor vehicles may not normally cross national borders in island States). The application to mobile assets of the general conflict-of-laws rule for tangible assets would require the secured creditor to ascertain the exact location of each piece of machinery or each vehicle at the time of the creation of the security right. To ensure continued third-party effectiveness of its security right, the secured creditor would also need to enquire as to all States in which each of these assets might be potentially located at any given time and meet the relevant requirements of all such States. Moreover, it would not be possible to identify the State in which the relevant asset would be located at the time of a priority contest occurring in the future and therefore to determine the priority regime to be applied to resolve the dispute. To avoid these problems and resulting costs and uncertainties, in some States, the creation, third-party effectiveness and priority of a security right in tangible assets of a type ordinarily used in more than one State may be governed by the law of the State in which the grantor is located (except if ownership of assets of that type is subject to registration in a special registry which also allows for the registration of security rights; see para. 37 below). The Guide follows this approach (see recommendation 201).

(ii) Tangible assets subject to specialized registration or notation on a title certificate

37. The ownership of certain categories of tangible assets is sometimes recorded in specialized registries or evidenced by a title certificate. This is generally the case for aircraft and ships and, in some States, for motor vehicles. To the extent that the relevant registry or notation system also permits the registration or notation of security rights, reference can be made to the law of the State under the authority of which the relevant registry is maintained, or the title certificate is issued, to determine the law governing the creation, third-party effectiveness and priority of a security right in an asset that is subject to registration in such a specialized registry or notation on a title certificate. Thus, a search in the registry, or an examination of the title certificate, would disclose both ownership and security rights in respect of such assets. Such a rule may be based on national law (see recommendation 202) or international conventions, which take precedence (e.g. the Convention on International Interests in Mobile Equipment and the relevant protocols thereto).

4. Law applicable to the creation, third-party effectiveness and priority of a security right in intangible assets

(a) General rule: law of the location of the grantor

38. In some States, the creation, third-party effectiveness and priority of a security right in intangible assets is governed by the law of the States in which the grantor is located. For example, if an exporter located in State A creates a security right in receivables owed by customers located in States B and C, the law of State A will govern the property right aspects of the security right. This rule is consistent with

the approach followed in the United Nations Assignment Convention with respect to the law applicable to the assignment of receivables (see articles 22 and 30).

39. In other States, the law of the location of the asset (*lex situs*) still governs the creation, third-party effectiveness and priority of a security right in intangible assets. In those States, it is necessary to establish the location of an intangible asset (e.g. for a receivable, the location of the debtor of the receivable).

40. The law of the grantor's location has several advantages over the *lex situs*, especially where the encumbered intangible assets consist of receivables. One single law applies even if the assignment relates to many receivables owed by different debtors. In addition, the law of the grantor's location may be ascertained easily at the time the assignment is made, even if the assignment relates to future receivables or to receivables assigned in bulk. Moreover, the law of the grantor's location (place of central administration in the case of a grantor having places of business in more than one State) is the law of the State in which the main insolvency proceedings with respect to the grantor are likely to be administered.

41. It is also the case that, while the law of the location of the encumbered asset (*lex situs*) works well in most instances for tangible assets, great difficulties arise in applying the *lex situs* to intangible assets, both at conceptual and practical levels. From a conceptual standpoint, there is no consensus and no clear answer as to the *situs* of a receivable. One view is that it is the place where payment must be made. Another view is that the *situs* of a receivable is the legal domicile or place of business or principal residence of the debtor of the receivable. A further view is that a receivable should be deemed to be located in the State whose law governs the contractual relationship between the original creditor (that is, the grantor) and the debtor of the receivable. Any of the foregoing alternatives would impose upon a prospective assignee the burden of having to make a detailed factual and legal investigation. Moreover, in many instances, it might prove impossible for the assignee to determine with certainty the exact location of a receivable since the criteria for determining that location may depend on business practices or the will of the parties to the contract under which the receivable arises. Thus, using the *lex situs* as the law applicable to security rights involving receivables would not provide certainty and predictability, which are key objectives for a sound conflict-of-laws regime in the area of secured transactions.

42. Furthermore, even if a State had detailed provisions allowing a prospective or existing secured creditor to ascertain easily and objectively the law of the location of a receivable, practical difficulties would still ensue in many commercial transactions. This would be so because a security right may relate not only to an existing and specifically identified receivable, but also to many other receivables. Thus, a security right may cover a pool of present and future receivables. In such a case, selecting the *lex situs* as the law governing priority would not be an efficient policy decision, as different priority rules might apply with respect to the various assigned receivables. Moreover, where future receivables are subject to a security right, it would not be possible for the secured creditor to ascertain the extent of its priority rights at the time of the transaction, since the *situs* of those future receivables is unknown at that time.

43. In view of the above, the Guide recommends that the creation, third-party effectiveness and priority of a security right in an intangible asset be governed

in general by the law of the State in which the grantor is located (see recommendation 205). The criteria defining the grantor's location are consistent with those found in the United Nations Assignment Convention (see paragraphs 21 and 70; see also recommendation 216).

(b) Exceptions for certain types of asset

44. There are three categories of intangible asset in respect of which different considerations apply and the location of the grantor is not the most (or the only) appropriate connecting factor for the selection of the applicable law: rights to payment of funds credited to a bank account; rights to receive the proceeds under an independent undertaking; and receivables arising from a transaction relating to immovable property.

(i) Rights to payment of funds credited to a bank account

45. With respect to the creation, third-party effectiveness, priority and enforcement of a security right in rights to payment of funds credited to a bank account, different approaches are followed in various States (for the definition of "bank account", see Introduction, section B, Terminology). For sake of simplicity and because a bank deposit is a receivable, some States consider that the governing law for receivables in general should also apply to a bank account. A different approach is to refer to the law of the State in which the branch maintaining the account is located (see recommendation 207, alternative A). Under this approach, certainty and transparency with regard to the applicable law would be enhanced, as the location of the relevant branch could be easily determined in a bilateral bank-client relationship. In addition, such an approach would reflect the normal expectations of parties to current banking transactions. Moreover, this approach would result in the law governing a security right in a right to payment of funds credited to a bank account being the same as that applicable to regulatory matters. The location of the branch is often viewed as the *situs* of a bank account for regulatory or other matters in respect of which the *situs* of the account must be ascertained.

46. Another approach is to refer to the law specified in the account agreement as the law governing the account agreement, or to any other law explicitly specified in the account agreement, provided that the depositary bank has a branch in the State whose law is so specified. If the account agreement does not specify any law, the applicable law could be determined using the same default criteria as those found in article 5 of the Hague Securities Convention (see recommendation 207, alternative B). Under this approach, the applicable law would meet the expectations of the parties to the account agreement. Third parties would be able to ascertain the law provided in the account agreement, as the grantor-account holder would normally supply information on the account agreement to obtain credit from a lender relying on the funds credited to the account.

47. As is the case with negotiable instruments and for the same reasons, the law of the State of the grantor's location could apply to the third-party effectiveness of a security right in a right to payment of funds credited to a bank account where third-party effectiveness may be achieved by registration in the place where the grantor has its location (see para. 34 above and recommendation 208).

(ii) *Rights to receive the proceeds under an independent undertaking*

48. In many States, the third-party effectiveness and priority of a security right in the right to receive the proceeds under an independent undertaking are referred to the law specified in the independent undertaking (for the definition of “right to receive the proceeds under an independent undertaking”, see Introduction, section B, Terminology; for this approach, see recommendation 209). If the governing law is not specified in the independent undertaking, those matters are referred to the law of the State of the location of the relevant office of the person that has provided (or has agreed to perform, as the case may be) the undertaking (see recommendation 210). This approach is viewed as being the most closely connected to the undertaking with respect to the law applicable to those matters. It is also consistent with the normal expectations of parties to such transactions. As to the creation of a security right in such an asset, the general conflict-of-laws rule for intangible assets continues to apply in view of the fact that creation only involves the effectiveness of the security right as between the parties to the security agreement and does not affect the rights of other parties.

49. However, if an independent undertaking is issued to ensure the performance of an obligation under a receivable or negotiable instrument, the law governing the creation and third-party effectiveness of a security right in the receivable or negotiable instrument will determine whether the security right extends automatically to the independent undertaking (see recommendation 211). This approach is justified by the need to apply, for consistency reasons, the same law to the creation and third-party effectiveness of the security right in the receivable or negotiable instrument and in the right to receive the proceeds under a related independent undertaking.

(iii) *Receivables related to immovable property*

50. Where a receivable arises from the sale or lease of immovable property or is secured by immovable property, as for any other receivable, the law of the State of the location of the grantor should normally govern the property aspects of a security right in the receivable. However, in the event of a priority contest where at least one of the competing claimants has registered its right in the immovable property registry of the State in which the immovable property is located, the Guide recommends that the priority contest be resolved in accordance with the law the State under whose authority the registry is maintained (see recommendation 206). The purpose of the latter rule is to ensure that the law of the State maintaining the registry actually applies to parties that are entitled by that law to rely on the registry. For the same reason, this rule is confined to a situation where, under the law of the State of the registry, registration in the registry is relevant for priority issues.

5. Law applicable to the creation, third-party effectiveness and priority of a security right in proceeds

51. There are generally three approaches to the law applicable to the creation, third-party effectiveness and priority of a security right in proceeds (for the definition of “proceeds”, see Introduction, section B, Terminology).

52. One approach is to refer, for the law applicable to a security right in proceeds, to the law applicable to the security right in the original encumbered assets.

For example, if the original encumbered assets are in the form of inventory located in State A and the proceeds take the form of receivables and the grantor is located in State B, the law of State A would apply to the creation, third-party effectiveness and priority of a security right in the receivables. Hence, a priority conflict between a security right in receivables as proceeds of inventory and a security right in receivables as original encumbered assets would be governed by the law of State A (the law of the location of the inventory). As a result, certainty as to the applicable law would be enhanced for the benefit of the inventory financiers relying on the receivables as proceeds.

53. However, this approach has significant disadvantages for the receivables financier. For example, it would result in the application of a law other than the law receivables financiers would expect to apply to their rights in the receivables as original encumbered assets. Another disadvantage is that the receivables financier would be unable to predict what the applicable law would be because the governing law would depend on whether the dispute arises with an inventory financier (in which case the law of the location of the inventory would govern) or with another competing claimant (in which case the law of the location of the grantor would govern). This approach also provides no solution in a tripartite dispute among the receivables financier, the inventory financier and another competing claimant. This approach would also undermine the choice of the law of the grantor's location as the law applicable to a security right in receivables because receivables often result from the sale of tangible assets. The receivables financier in many instances then would be unable to rely on the law of grantor's location.

54. A second approach is to refer to the law applicable to security rights in assets of the same type as the proceeds. In the example given above, the law of State B (the law of the grantor's location) would apply to the creation, third-party effectiveness and priority of a security right in the receivables. Simplicity and certainty considerations would support such an approach: it would always be possible to determine the applicable law irrespective of the parties to the dispute.

55. Yet a third approach is to combine the two approaches mentioned above and retain the second approach as the rule for third-party effectiveness and priority of a security right in proceeds, while the first approach would apply to the creation of that right. Under this third approach, the question of whether a security right extends to proceeds would be governed by the law applicable to the creation of a right in the original encumbered assets from which the proceeds arose, while the third-party effectiveness and priority of a security right to proceeds would be subject to the law that would have been applicable to such issues if the proceeds had been original encumbered assets.

56. This approach would meet the expectations of a creditor obtaining a security right in inventory under a domestic law providing that such security right automatically extends to proceeds. It would also meet the expectations of receivables financiers as to the law that would apply to the creation, third-party effectiveness and priority of a security right in receivables as original encumbered assets. Finally, such an approach would ensure that the inventory financier could rely on the law governing its security right as to whether the right extends to proceeds and would allow all competing claimants to identify with certainty the law that will govern a potential priority contest. For all these reasons, this is the approach recommended in the Guide (see recommendation 212).

6. Law applicable to the rights and obligations of the parties to the security agreement

57. As mentioned above (see para. 11), the scope of the rules on the creation, third-party effectiveness and priority of a security right is confined to the property (in rem) aspects of the right. These rules do not apply to the mutual rights and obligations of the parties to the security agreement. Such rights and obligations are rather governed by the law chosen by them or, in the absence of a choice of law, by the law governing the agreement as determined by the conflict-of-laws rules generally applicable to contractual obligations (see recommendation 213). For example, in a State in which the Rome Convention is in effect, in the absence of a choice of law by the parties, the mutual rights and obligations of the parties to the security agreement will be subject to the law most closely connected to the security agreement (see article 4, paragraph 1, of the Rome Convention). A loan agreement whereby a security right is also granted may be presumed to be most closely connected with the State in which the party that performs the obligation that is characteristic of the agreement has its central administration or habitual residence (see article 4, paragraph 2, of the Rome Convention). In such a loan agreement, this party may be the lender. In a retention-of-title sale, it may be the seller.

7. Law applicable to the rights and obligations of third-party obligors

58. Security rights in intangible assets generally involve third parties such as, for example, the debtor of a receivable, an obligor under a negotiable instrument, the depositary bank, the guarantor/issuer, confirmer or nominated person in an independent undertaking or the issuer of a negotiable document. The conflict-of-laws rules governing the property aspects or the enforcement of a security right are not necessarily appropriate for the determination of the law applicable to the obligations of third parties against whom the secured creditor may want to exercise the recourses arising from its security right. Applying these rules would frustrate the expectations of parties that have payment or other obligations arising in connection with the encumbered asset but do not take part in the transaction to which the security agreement relates.

59. In particular, the fact that a receivable has been encumbered by a security right should not result in the obligations of the debtor of the receivable becoming subject to a law different from the law governing the receivable. Similar considerations apply to the obligations of the obligor under a negotiable instrument, the depositary bank, the guarantor/issuer, confirmer or nominated person in an independent undertaking or the issuer of a negotiable document where a security right has been granted in a negotiable instrument, right to payment of funds credited to bank accounts or proceeds under an independent undertaking, or a negotiable document. It is generally accepted that the existence of the security right should not displace the law applicable to the relationship of all such parties with the grantor and that such law should also govern their relationship with the secured creditor. The conflict-of-laws rules proposed by the Guide follow this approach (see recommendation 214).

8. Law applicable to the enforcement of a security right

60. In most States, procedural matters are governed by the law of the State where the relevant procedural step is taken. However, enforcement may relate to

substantive or procedural matters. Although the forum State will use its own law to determine what is substantive and what is procedural, the following are examples of issues generally considered to be substantive: the nature and extent of the remedies available to the creditor to realize the encumbered assets; whether such remedies (or some of them) may be exercised without judicial process; the conditions to be met for the secured creditor to be entitled to obtain possession and dispose of the assets (or to cause the assets to be judicially realized); the power of the secured creditor to collect receivables that are encumbered assets; and the obligations of the secured creditor to the other creditors of the grantor.

61. With respect to substantive enforcement matters, where a security right is created and made effective against third parties under the law of one State, but is sought to be enforced in another State, the question arises as to the law applicable and thus the remedies available to the secured creditor. This is of great practical importance where the substantive enforcement rules of the two States are significantly different. For example, the law governing the security right could allow enforcement by the secured creditor without prior recourse to the judicial system, while the law of the place of enforcement might require advance judicial intervention. Each of the possible solutions to this issue entails advantages and disadvantages.

62. One approach would be to refer enforcement remedies to the law of the place of enforcement, i.e. the law of the forum State (*lex fori*). The place of enforcement of security rights in tangible assets in most instances would be the place of the location of the asset, while enforcement of a security right in intangible assets such as a receivable might take place in the location of the debtor of the receivable. The policy reasons in favour of this approach are, among others, that:

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

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

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

63. On the other hand, selecting the *lex fori* may result in uncertainty if the encumbered asset is an intangible asset. For example, it is not clear where enforcement is to take place if the encumbered assets are in the form of receivables. The answer to this question could be very problematic as it would require the criteria for determining the location of the receivables to be set out (see para. 41 above). In addition, the secured creditor might be located in a different State at the time the initial enforcement steps are taken. In the case of a bulk assignment involving receivables owing by debtors located in several States, multiple laws may apply to enforcement. The difficulty would be the same if one enforcement act would have to be performed in one State (e.g. notification of the debtor of the receivable) and another act in another State (e.g. collection or sale of the receivable). If future receivables are involved, the secured creditor may not know at the time of the assignment which law would govern its enforcement remedies.

All this uncertainty as to the applicable law may have a negative impact on the availability and the cost of credit.

64. Another concern is that the *lex fori* might not give effect to the intention of the parties. The parties' expectations may be that their respective rights and obligations in an enforcement situation will be those provided by the law under which the priority of the security right will be determined. For example, if extrajudicial enforcement is permitted under the law governing the priority of the security right, this remedy should also be available to the secured creditor in the State where it has to enforce its security right, even if it is not generally allowed under the domestic law of that State.

65. So, another approach would be to refer substantive enforcement matters to the law governing the priority of a security right. The advantage of this approach would be that enforcement matters are closely connected with priority issues (e.g. the manner in which a secured creditor will enforce its security right may have an impact on the rights of competing claimants). Such an approach may have another benefit. As the law governing priority is often the same law as the law governing the creation and third-party effectiveness of the security right, the final result would be that creation, third-party effectiveness, priority and enforcement issues would often be governed by the same law.

66. A third possible approach would be a rule whereby the law governing the contractual relationship of the parties would also govern enforcement matters. This approach would result in an applicable law that would often correspond to the parties' expectations. In addition, in many instances, under such an approach, the applicable law would coincide with the law applicable to the creation of the security right, since that law is frequently selected as also being the law of their contractual obligations. However, under this approach, parties would then be free to select, for enforcement issues, a law other than the law of the forum State or the law governing priority. This solution would be disadvantageous to third parties that might have no means to ascertain the nature of the remedies that could be exercised by a secured creditor against the assets of their common debtor. Therefore, referring enforcement issues to the law governing the contractual relationship of the parties would necessitate exceptions designed to take into account the interests of third parties, as well as the mandatory rules of the forum State, or of the law governing creation, third-party effectiveness and priority.

67. A fourth approach would be to attempt to reconcile the benefits of the approaches based on the law of the place of enforcement (*lex fori*) and the law governing priority. Under this approach, the enforcement of a security right in tangible assets may be governed by the *lex fori*, while the enforcement of a security right in intangible assets would be governed by the same law as the law that applies to priority. The Guide recommends this solution as it preserves the benefits of using the *lex fori* for tangible assets, while avoiding the difficulties that would arise if such law were to apply to intangible assets (see recommendation 215).

68. It must be noted that the above conflict-of-laws rules on enforcement do not govern the relationship between a secured creditor and third-party obligors. As mentioned above (see paragraph 59), the obligations of such persons to the secured creditor are generally governed by the same law that was applicable to their relationship to the grantor.

9. Rules and relevant time for the determination of location

69. As the general conflict-of-laws rules for security rights in tangible and intangible assets point to the location of the encumbered assets and the location of the grantor, respectively, it is essential that the appropriate location be easily identified. Tangible assets are commonly viewed as being located at the place where they are physically located and there is no need to provide a specific rule to that effect. There is such a need, however, for the determination of the location of the grantor. The legal domicile and the residence of a natural person might be in different States. Likewise, a legal person may have its statutory head office in a State other than the State in which its principal place of business or decision centre is located.

70. As mentioned above, the United Nations Assignment Convention defines the location of the grantor as follows: the grantor's location is its place of business or if the grantor has places of business in more than one State, the place where the central administration of the grantor is exercised. If the grantor has no place of business, reference is then made to the grantor's habitual residence (see article 5, subparagraph (h)). The Guide defines the location of the grantor in the same manner (see recommendation 216).

71. Whatever connecting factor is retained for determining the most appropriate conflict-of-laws rule for any given issue, there may be a change in the relevant factor after a security right has been created. For example, where the applicable law is that of the State where the grantor has its head office, the grantor might later relocate its head office to another State. Similarly, where the applicable law is the law of the State where the encumbered assets are located, the assets may be moved to another State. So, it is also necessary to determine the time that is relevant for the determination of location.

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

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

74. Thus, providing guidance on these issues is necessary to allow interested parties to determine with certainty whether a change in the connecting factor would result in the application of a law other than the law initially expected by the parties

to apply if the State of the new location of the assets or the grantor has a different conflict-of-laws rule. Therefore, the Guide proposes to make explicit the interpretation referred to in paragraph 73: for the purpose of determining the law applicable to creation, the relevant location should normally be the location of the encumbered asset or the grantor at the time of putative (purported or asserted) creation; for the purpose of determining the law applicable to third-party effectiveness and priority, the relevant location should be the location at the time the issue arises. However, in a dispute involving only competing claimants whose rights became effective against third parties before a change in location of the asset or the grantor, third-party effectiveness and priority issues should be governed by the law of the initial location (see recommendation 217).

10. Public policy and internationally mandatory rules

75. According to the conflict-of-laws rules of many States, the forum State may refuse the application of the law determined under its conflict-of-laws rules only if the effect of its application would be manifestly contrary to the public policy of the forum State or to provisions of the law of the forum State that are mandatory even in international situations. This rule is intended to preserve fundamental principles of justice of the forum State. For example, if, under the law of the forum State, a security right cannot be created in retirement benefits and this is a matter of public policy in the forum State, the forum State may refuse to apply a provision of the applicable law that would recognize the creation of such a right. However, these principles should not permit the forum State to apply its own third-party effectiveness and priority rules in the place of those of the applicable law (see recommendation 219). The forum State has to apply other provisions of the applicable law to determine third-party effectiveness and priority. This approach is justified by the need to achieve certainty with respect to the law applicable to third-party effectiveness and priority. The same approach is followed in articles 23, paragraph 2, 30, paragraph 2, and 31 of the United Nations Assignment Convention. It is also followed in article 11, paragraph 3, of the Hague Securities Convention.

11. Impact of commencement of insolvency proceedings on the law applicable to security rights

76. Determining the law applicable to the creation, third-party effectiveness and priority of a security right and the post-default rights of a secured creditor may raise additional issues when insolvency proceedings are commenced in one State and some of the debtor's assets or creditors are located in another State, or when insolvency proceedings are commenced in two different States owing to the multinational nature of the debtor's business. In either instance, however, most States provide that general conflict-of-laws rules applying outside of insolvency proceedings would govern these matters, subject to the limitations discussed below. This result is consistent with recommendation 30 of the *UNCITRAL Insolvency Guide*, which provides that the State in which insolvency proceedings are commenced (i.e. the forum State) should apply its conflict-of-laws rules to determine which State's law governs such questions as the validity and effectiveness of rights and claims (including security rights) existing at the time of the commencement of insolvency proceedings (see also recommendation 220 of this Guide).

77. Once, under the non-insolvency law applicable outside of insolvency proceedings by virtue of the conflict-of-laws rules of the forum State, the validity and effectiveness of a security right are determined, a second issue arises concerning the effect of commencement of insolvency proceedings on the priority of security rights. It is generally recognized that the insolvency law of the State in which the insolvency proceedings are commenced (*lex fori concursus*) governs the commencement, conduct, including the ranking of claims, administration and conclusion of the proceedings (the “insolvency effects”) (see recommendation 31 of the *UNCITRAL Insolvency Guide*). This may have the effect of changing the relative priority that a security right would have under secured transactions law, and establish categories of claims that would receive distributions ahead of a security right in insolvency proceedings. In addition, irrespective of priority issues a security right might be subject to the avoidance provisions of the insolvency law (see recommendation 88 of the *UNCITRAL Insolvency Guide*).

78. While the insolvency effects of insolvency proceedings on security rights typically are governed by the *lex fori concursus*, some States have adopted exceptions. For example, a forum State may defer to the insolvency law of the State in which immovable property is located (*lex rei sitae*) for the insolvency effects on a security right in attachments to the immovable property. The *UNCITRAL Insolvency Guide* addresses these exceptions in more detail (see part two, chapter I, paras. 85-91), but does not recommend the adoption of a *lex rei sitae* rule for insolvency effects as applied to attachments to immovable property or even to movable property in general. Instead, it generally recommends that any exceptions to the applicability of the *lex fori concursus* for insolvency effects should be limited in number and clearly set forth in the insolvency law (see *UNCITRAL Insolvency Guide*, recommendation 34 and part two, chapter I, para. 88).

12. Special recommendations when the applicable law is the law of a multi-unit State

79. The term “State” in the Guide refers to a sovereign State or country. The question arises, however, as to what law applies if, on a given issue, the conflict-of-laws rule refers to a State that comprises more than one territorial unit, with each unit having its own system of law in relation to the issue. This could be the case in federal States in which the secured transactions law generally falls under the legislative authority of their territorial units. For the conflict-of-laws rules to work where the applicable law is the law of such a State (even if the forum State is not a multi-unit State), it is necessary to determine the territorial unit whose law will apply.

80. Normally, references to the law of such a State are to the law in effect in the relevant territorial unit, as determined on the basis of the applicable connecting factor (such as the location of the asset or the location of the grantor). For instance, if the applicable law is the law of a multi-unit State with three territorial units (A, B and C), a reference to the law of the location of the grantor as the law applicable to a security right in receivables means a reference to the law of unit A if the place of central administration of the grantor is in unit A (see recommendation 221).

81. To preserve the consistency of the internal conflict-of-laws rules of a multi-unit State, the Guide adopts an approach followed by many international conventions and recommends that such rules continue to apply, but only internally

(see recommendation 222). Using the example given in the preceding paragraph, if a grantor is located in unit A of a multi-unit State, the law of unit B would apply where the internal conflict rules of unit A would point to the law of unit B as the applicable law. This could be the case if the conflict rules of unit A contemplate (as in the Guide) that the law of the grantor's location governs the third-party effectiveness and priority of a security right in receivables but defines location differently. If the location of the grantor as defined in the Guide (that is, the place of central administration) is in unit A but the law of unit A defines the grantor's location as meaning the location of its statutory head office and such office of the grantor is in unit B, then the third-party effectiveness and priority of the security right in the receivables will be governed by the law of unit B. This appears to be a deviation from the general rule on the exclusion of renvoi (see recommendation 218). However, this "deviation" is limited to internal renvoi, which does not affect certainty as to the applicable law. In the above example, there would be no reference to a law other than that of unit A should the statutory head office of the grantor be located in a State other than the State of which unit A forms part.

82. These rules on multi-unit States are relevant only to issues that, in such a State, are governed by the laws of its territorial units. So, for example, these rules would have no impact in a federal State whose constitution provides that secured transaction matters are governed by federal laws.

83. Recommendations 223 and 224 apply only if a State adopts alternative B of recommendation 207.

B. Recommendations

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

A/CN.9/637/Add.7 [Original: English]

**Note by the Secretariat on terminology recommendations of the UNCITRAL draft
Legislative Guide on Secured Transactions, submitted to the Working Group on
Security Interests at its twelfth session**

ADDENDUM

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XIII. Transition

A. General remarks

1. The need for transition provisions

1. The previous chapter addressed “conflict of laws”, that is, the set of rules to determine, in cases where two or more legal systems have substantive rules that might apply to a particular transaction, which substantive rules will in fact apply. Often these conflict-of-laws rules are described as rules governing conflict of laws “in space”, in order to distinguish them from a different type of conflict-of-laws

rules (i.e. those governing conflict of laws “in time”). All legislative action raises issues relating to the conflict of laws in time. Hence, most States have well-developed principles to determine, when a new law comes into force, its impact on inconsistent prior law and the extent of its application to existing legal relationships. Where, however, a major reform to existing law is contemplated, States usually incorporate into the reform statute specific rules governing conflict of laws in time as they arise in connection with the coming into force of the new law. These rules are typically known as “transition provisions”. In view of the scope of preceding chapters, the Guide recommends that States adopt a series of transition provisions tailored specifically to the new law they may enact.

2. The rules embodied in new secured transactions legislation reflecting the recommendations of the Guide are likely to depart in significant ways from the rules in the secured transactions law predating the legislation. Those differences will have an obvious impact on any agreements that grantors and secured creditors conclude after the new legislation is enacted. However, many transactions concluded under the prior law will be ongoing when the new law comes into force. In light of the differences between the old and new legal regimes and the continued existence of transactions and security rights created under the old regime, it is important for the success of the new legislation that it contain fair and efficient rules governing the transition from the old law to the new law. A similar need for transition rules is present when, under the conflict-of-laws rules of the old regime, the law of a different State (i.e. different from the State whose law governs that issue under the conflict-of-laws rules of the new regime) governed the creation, effectiveness against third parties or priority of a security right.

3. Two issues related to the transition from the old regime to the new law must be addressed. First, as discussed in section A.2, the new legislation should provide the date as of which it (or dates as of which its various parts) will come into force (the “effective date”; see recommendation 223). Second, as discussed in section A.3, the new legislation should also set forth the extent to which, after the effective date, the new legislation applies to transactions or security rights that existed before the effective date.

2. Effective date of new legislation

4. A number of factors require consideration in determining the effective date of the legislation. Prompt realization of the economic advantages of new legislation is a reason for States to bring the new law into force as soon as possible after enactment. These advantages must be balanced, however, against the need to avoid causing instability in, or disruption of, the markets that will be governed by the new legislation, and to allow market participants adequate time to prepare for conducting transactions under the new legislation, which may be significantly different from transactions under the prior law. Accordingly, and depending on the extent to which the new legislation had been the subject of public discussion (including substantial educational programmes for judges, lawyers and market participants), a State may conclude that the effective date of the new legislation should be some period of time after the enactment of the new legislation, in order for these markets and their participants to adjust their conduct in preparation for the new rules.

5. In determining the effective date, States might consider various factors including the following: the impact of the effective date on credit decisions;

maximization of benefits to be derived from the new legislation; the necessary regulatory, institutional, educational and other arrangements or infrastructure improvements to be made by the State; the status of the pre-existing law and other infrastructure; the harmonization of the new secured transaction legislation with other legislation; constitutional limits, if any, to the retroactive effect of new legislation; and standard or convenient practice for the entry into force of legislation (e.g. on the first day of a month).

6. States generally adopt one of three methods for bringing legislation into force at a date subsequent to enactment. First, it is provided that a law comes into force on a future date fixed by a “decree” or a “proclamation”. In other cases, the law itself will specify that future date. For example, if a law were enacted on 17 January of a given year, that law might simply provide that it comes into force on 1 September of the same year. In still other cases, the legislation will contain a specific formula for determining its effective date. For example, the law might provide that the effective date will be the first day of the calendar month following the expiration of six months after the date of enactment. A second formula might refer to the first day of January or July, whichever occurs first, following the expiration of six months after the date of enactment. Under a third formula, it is necessary to delay the effective date in order to allow time to build a technical infrastructure (such as a computerized registry). In these cases, States often use a “decree” to the effect that, for example, the date the registry becomes operational will be the starting point for the six-month or longer delay. The Guide recommends that States either specify the effective date, or set out a formula for determining the effective date in the law itself (recommendation 223).

7. As debts that are secured by rights in the grantor’s assets are often payable over a period of time, it is likely that there will be many rights created before the effective date that will continue to exist on and after the effective date, securing debts that are not yet paid. Therefore, States also must consider whether the new legislation should apply to issues that arise after the effective date when these issues relate to transactions entered into prior to the effective date.

8. One approach would be for the new legislation to apply prospectively only and, therefore, not to govern any aspects of any transactions entered into prior to the effective date. While there might be some appeal in such a solution, especially with respect to issues that arise between the grantor and the secured creditor, such an approach would create significant problems, especially with respect to priority issues. Foremost among those problems would be the necessity of resolving priority disputes between a secured creditor that obtained its security right prior to the effective date and a competing secured creditor that obtained its security right in the same encumbered assets after the effective date. Because priority is a comparative concept, and the same priority rule must govern the two security rights that are being compared, it is not practicable for the old rules to govern the priority of the security right of the pre-effective-date creditor and the new rules to govern the priority of the security right of the post-effective-date creditor. Determining which priority rule to apply to such priority disputes is not without difficulty. Applying the old rules to such priority disputes would essentially delay the effectiveness of some of the most important aspects of the new legislation, with the result that significant economic benefits of the new legislation could be deferred for a substantial period. The delay would affect all new transactions even though it would be needed for only

some of the old transactions. Moreover, the delay would prevent parties with security agreements that cover future assets from taking advantage of the new law for assets acquired after its effective date. On the other hand, applying the new rules to such priority disputes might unfairly prejudice parties that relied on the old law (especially those parties that relied on the old law without notice that the law might be changed) and might also provide an incentive for such parties to object to the new legislation or advocate an unduly delayed effective date.

9. Alternatively, greater certainty and earlier realization of the benefits of the new legislation could be promoted by applying the new legislation to all transactions as of the effective date, but with such transition provisions as are necessary to assure an effective transition to the new regime without loss of pre-effective-date priority status. Such an approach would avoid the problems identified above and would otherwise fairly and efficiently balance the interests of parties that complied with the old law with the interests of parties that comply with the new law.

10. Taking into account these considerations, the Guide recommends the second of these two general approaches: (a) immediate application of the new law to all transactions arising after its effective date; (b) no general retroactive application of the new law to transactions entered into prior to its effective date; (c) application of the new law to issues and procedures (for example, priority disputes and enforcement mechanisms) arising after its effective date; and (d) adoption of transition provisions to protect the rights that parties acquired under transactions concluded prior to the effective date (recommendation 223, second sentence).

3. Issues to be addressed by transition provisions

(a) General

11. Many security rights created before the effective date of the new law will continue to exist after the effective date and may come into conflict with security rights created under the new law. Clear transition provisions are thus needed to determine the extent to which the rules in the new legislation will apply to those pre-existing security rights. These transition provisions should appropriately address both the settled expectations of parties and the need for certainty and predictability in future transactions. The transition provisions must address the extent to which the new rules will apply, after the effective date, as between the parties to a transaction that created a security right before the effective date. They must also address the extent to which the new rules will apply, after the effective date, to resolve priority disputes between a holder of a security right and a competing claimant, when either the security right or the right of the competing claimant was created before the effective date.

12. No single rule or formula to govern all cases is possible because, even if all States were to implement the Guide in identical fashion, each State would be transitioning from a different pre-existing regime. Further, the particularities of the pre-existing regime will have an effect on the decisions made with respect to transition, such as how easy it will be to determine that assets were subject to a security right under the old regime, or how long transactions could go on “untouched” (e.g. whether, under the old regime, there would not be a need for renewal or other action to maintain third-party effectiveness). The discussion that

follows reviews the principal issues that States must address in elaborating a series of transition provisions.

(b) Disputes before a court or arbitral tribunal

13. When a dispute is in litigation at the effective date, the rights of the parties have sufficiently crystallized so that the coming into force of a new legal regime should not change the outcome of that dispute. The same principle should apply when the dispute is taken before a comparable dispute resolution system, such as arbitration, although it should not apply when a system such as conciliation is being used by the parties (as the non-binding character of the result of the proceedings indicates that the rights of the parties have not sufficiently crystallized). It follows, therefore, that such a dispute should not be resolved by application of the new legal regime (see recommendation 224). Moreover, within the context of ongoing enforcement proceedings, parties to the dispute should generally not be able to avail themselves of mechanisms or rights provided in the new law. Litigation may involve matters other than enforcement. In these cases, ongoing litigation on one aspect of a secured transaction should not preclude the application of the new law to aspects of the transaction that are not the subject of litigation. Nor should it prevent parties from commencing litigation on any such matters under the new law.

(c) Effectiveness of pre-effective-date rights as between the parties

14. When a security right has been created before the effective date of new legislation, two questions arise regarding the effectiveness of that right between the grantor and the creditor. The first question is whether a security right that was effectively created under the old law but does not fulfil the requirements for creation under the new law will become ineffective on the effective date of the new law. The second question is whether a security right that was not effectively created under old law but fulfils all the requirements for creation of a security right under the new law will become effective on the effective date of the new law.

15. With respect to the first question, different approaches are also possible. For example, a transition period might be created during which the security right would remain effective between the parties, so that the creditor could take the necessary steps for creation under the new law during the transition period. At the expiration of the transition period, if such steps had not been taken the right would become ineffective under the new law. On the other hand, a simpler approach (and the approach adopted by the Guide) is to provide that, if a security right is created (that is, is effective between the parties) before the effective date of the new law, it remains effective between them after the new law comes into force (see recommendation 225).

16. With respect to the second question, consideration should be given to making the right effective as of the effective date of the new law, since the parties presumably intended the right to be effective as between them when they entered into their agreement. Nonetheless, some States address this issue by requiring a confirmation by the grantor that it intends the previously ineffective right to be effective under the new law. Such a requirement is difficult to put into practice, however, since it presumes, implausibly, that at least one of the parties knew of the defect, failed to do anything to correct it under the old law, but now wishes the security right to be effective. The more likely case involves the discovery of the

defect after the new law came in force, in which case a rule providing for automatic effectiveness upon the coming into force of the new law is justified. This is the position implicitly recommended in the Guide (recommendation 223, second sentence).

(d) Effectiveness of pre-effective-date rights as against third parties

17. Different issues arise as to the effectiveness against third parties of a right created before the effective date of the new law. As the new legislation will embody public policy regarding the proper steps necessary to make a right effective against third parties, it is preferable for the new rules to apply to the greatest extent possible. It may, however, be unreasonable to expect a creditor whose right was effective against third parties under the previous legal regime of the enacting State (or under the law of the State whose law applied to third-party effectiveness under the conflict-of-laws rules of the old regime) to comply immediately with any additional requirements of the new law. The expectation would be especially onerous for institutional creditors, which would be required to comply with the additional requirements of the new law simultaneously for large numbers of pre-effective-date transactions.

18. A preferable approach would be for a security right that was effective against third parties under the previous legal regime but would not be effective under the new rules to remain effective for a reasonable period of time (as specified in the transition provisions in the new law) so as to give the creditor time to satisfy the requirements of the new law. At the expiration of the transition period, the right would become ineffective against third parties unless it had become effective against third parties under the new law (see recommendation 226). In determining the length of time within which creditors are permitted to make their existing rights effective against third parties, States should consider a number of practical questions. For example, where a registry system for security rights already exists, a longer period might be contemplated since third parties would continue to have a means to determine if a security right encumbered particular assets. By contrast, where no registry system for security rights is in place, a shorter period might be considered (at least for rights for which a notice was not required to be registered under the old law), since third parties would not have an easy means to determine whether a security right encumbered a potential grantor's assets.

19. If the right was not effective against third parties under the previous legal regime, but is nonetheless effective against them under the new rules, the right should be effective against third parties immediately upon the effective date of the new rules. Once again, the presumption is that the parties intended effectiveness as between them, and third parties are protected to the full extent provided for in the new rules. This is the position implicitly recommended in the Guide (recommendation 223, second sentence).

(e) Priority disputes

20. An entirely different set of questions arises in the case of priority disputes because such disputes necessarily involve applying one set of rules to two (or more) different rights created at different times. A legal system cannot simply provide that the priority rule in effect at the time when a security right was created governs priority with respect to that right because such a rule would not provide a coherent

answer when one of the rights that is being compared was created under the former regime while the other was created under the new regime. Rather, there must be rules that address each of the following situations: (a) where both rights are created after the effective date of the new legislation; (b) where both rights are created before the effective date; and (c) where one right is created before the effective date and the other right is created after the effective date.

21. The easiest situation is a priority dispute between competing claimants whose rights were created after the effective date of the new legislation. In that situation, it is obvious that the priority rules in the new legislation should be applied to resolve that dispute.

22. Conversely, if both of the competing rights were created before the effective date of the new legislation and the relative priority of the two competing rights in the encumbered assets was established before the effective date of the new rules and, in addition, nothing (other than the effective date having occurred) has happened that would change that relative priority, stability of relationships suggests that the priority established before the effective date should not be changed merely because the new law came into force. If, however, something occurs after the effective date that would have had an effect on priority under the previous legal regime (such as a security right becoming effective against third parties or ceasing to be effective against third parties), there is less reason to continue to utilize the former law to govern a dispute that has been changed by an action or event that took place after the effective date. There is a much stronger argument for applying the new law to such a situation. In other words, the existing rights of parties as they stood when the new law came into force are protected, but parties should not be relieved of the obligation to make certain that they avoid acting (or failing to act) in such a way that their existing rights are no longer preserved under the new law (see recommendations 227-229).

23. The most difficult transition situation involves a priority dispute between one right that was created before the effective date and another right that was created after the effective date. In such a case, while it is preferable to have the new rules govern eventually (indeed, sooner rather than later), it is appropriate to provide a transition rule protecting the status of the creditor whose right was acquired under the old regime, provided that creditor takes whatever steps are necessary to maintain protection under the new regime. If those steps are taken within the time prescribed in the transition rule, the new legislation should provide that creditor with the same priority it would have enjoyed had the new rules been effective at the time of the original transaction and those steps had been taken in a timely fashion under the old law (see recommendation 227).

(f) Enforcement

24. Disputes may be in litigation (or an alternative dispute resolution system, such as arbitration) at the date when the new law comes into force. As noted, in these cases, the rights of the parties have sufficiently crystallized so that the effectiveness of a new legal regime should not change the outcome of that dispute (see recommendation 224). Parties to the dispute should generally not be able to avail themselves of mechanisms or rights provided in the new law. For example, if non-judicial enforcement is prohibited under prior law, but authorized under the new law, enforcing parties should not be able to convert the judicial enforcement

process into a non-judicial enforcement process. Likewise, within the context of ongoing enforcement proceedings, parties should not normally be permitted to invoke defences or other rights contained only in the new law. The scope of the principle is, however, open to interpretation. In one view, once a creditor has commenced enforcement under prior law, it should be deemed to have opted for enforcement under that law, and cannot thereafter attempt to avail itself of recourses available under the new law. In another view, the principle means only that the creditor cannot be forced to convert proceedings commenced under prior law into proceedings under the new law. It may continue to proceed with enforcement as if the new law had not yet come into force. If, however, the enforcing creditor were to abandon ongoing judicial or arbitral enforcement proceedings, in this view, nothing would prevent that creditor from commencing other enforcement proceedings (including non-judicial enforcement proceedings) under the new law. The Guide does not make a recommendation on which of these two approaches States should adopt in respect of ongoing enforcement proceedings.

25. Nonetheless, the vast bulk of disputes that involve transactions entered into before the coming into force of the new law will arise after the new law becomes effective. Two different situations can arise. On the one hand, it may be that secured creditors are entitled to exercise certain recourses and grantors are permitted to plead certain defences that are no longer permitted under the new law. On the other hand, it may be that the new law permits creditors to avail themselves of new remedies and permits debtors to plead new defences not previously permitted.

26. Where the new law abolishes certain remedies, or makes them subject to a new and more onerous procedure, there is an argument that creditors should not be prejudiced by the new law. For example, in some States, creditors in possession may, upon default, simply take the asset given in pledge without having to give notice to the grantor or third parties. The Guide, by contrast, contemplates that a creditor would have to give notice of its intention to accept the assets in satisfaction of the secured obligation (see recommendations 141-145).

27. A similar rationale applies to cases where grantors are deprived of defences or procedural rights that could be exercised under prior law. For example, in some States, grantors in default may suspend enforcement proceedings by remedying the particular omission that led to the default, thereby reinstating the secured obligation and stopping enforcement. The Guide, by contrast, contemplates that grantors have a right to redeem the security by paying the outstanding obligation, but have no right to cure the default and reinstate the obligation (see recommendation 139).

28. In both these cases, there is an argument that the prejudice potentially suffered by a secured creditor or a grantor with the coming into force of the new law is sufficient to justify not abolishing any rights arising under prior law, even in respect of enforcement that commences after the new law comes into force. Both should be able to enforce the original agreement according to the law in force when it was concluded. By contrast, there is an equally strong argument that because the new enforcement regime results from a State carefully considering how best to balance the rights of all parties, it should apply to all post-effective-date enforcement remedies. This argument is particularly persuasive when the enforcement will affect the rights of third parties that have taken security rights in the assets after the new regime comes into force. Moreover, because the relative balance to be struck depends on the particular configuration of secured creditors' enforcement rights and

grantors' rights in individual States under prior law, the Guide adopts the general principle of immediate application (see recommendation 223).

29. This said, other law in a State (for example, the general law of obligations or constitutional principles relating to retroactive interference with property rights) may affect the precise extent to which enforcement proceedings commenced after the new law comes into force are affected by the principle of immediate application.

30. As for the case where the new law provides creditors with new remedies, and grantors with new procedural rights, the argument for applying the new law to transactions existing prior to its coming into force is compelling. A secured creditor under prior law that has taken the steps necessary to ensure third-party effectiveness under the new law should be in no different a position than a creditor that initially takes security under the new law. Similarly, any new defences or procedural rights given to grantors and third parties under the new law should be available in connection with enforcement proceedings undertaken by all secured creditors, including those creditors enforcing rights arising under transactions that existed before the new law came into force. That is, the new enforcement regime reflects a State's best judgement as to a fair and efficient regime for enforcing security rights. If it is appropriate for security rights that have been created after the new law came into force, it should also apply to the post-effective-date enforcement of security rights created before the new law came into force.

B. Recommendations

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

A/CN.9/637/Add.8 [Original: English]**Note by the Secretariat on terminology recommendations of the UNCITRAL draft
Legislative Guide on Secured Transactions, submitted to the Working Group on
Security Interests at its twelfth session****ADDENDUM****CONTENTS**

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XIV. Insolvency

A. General remarks

1. Introduction

1. The preceding chapters of the Guide provide commentary and recommendations aimed at assisting States in the development of effective and efficient secured transactions laws. The goal has been to set out a framework for regulating the rights of grantors, secured creditors and third parties whenever grantors seek to encumber assets with a security right. The Guide generally does not address issues related to the basic law of obligations and property, nor does it directly address matters of civil procedure and the regime governing the enforcement of judgements. The Guide leaves these matters to other law. However, there is one field of law, i.e. insolvency law, where as a practical matter the regime of secured transactions deeply interacts with other law and thus needs to be directly addressed in this Guide.

2. Secured transactions laws and insolvency laws have different concerns and objectives, some of which may overlap where the rights regulated by a secured transactions law are affected by the commencement of insolvency proceedings. A secured transactions law seeks to promote secured credit, i.e. credit at a lower cost, because security lowers the risk of non-payment to the secured creditor (“default”). It allows debtors to use the full value of their assets to obtain credit, develop their business and avoid default. In the case of default by a debtor, a secured transactions law seeks to ensure that the value of the encumbered assets protects the secured creditor. It focuses on effective enforcement of the rights of individual creditors to maximize the likelihood that, if the secured obligations owed are not performed, the economic value of the encumbered assets can be realized to satisfy the secured obligations.

3. An insolvency law, on the other hand, is principally concerned with collective business and economic issues. It seeks, among other objectives, to preserve and maximize the value of the debtor’s assets for the collective benefit of creditors and to facilitate equitable distribution to creditors. The achievement of these objectives will be assisted by preventing a race among creditors to enforce individually their rights against a common debtor, and facilitating the reorganization of viable business enterprises and the liquidation of businesses that are not viable. For these reasons, an insolvency law may affect the rights of a secured creditor in different ways once insolvency proceedings commence.

4. Since reform of one law can impose unforeseen transaction and compliance costs on parties under the other law and create tension between the two laws, legislators revising existing laws or introducing a new law in the field of either insolvency or secured transactions will need to ensure that any new or revised law properly takes account of an existing or proposed law in the other field. In some cases, review of the law in one field may point to the need to revise or develop a new law in the other field. In any event, to the extent that an insolvency law affects the rights of secured creditors, those effects should be based on carefully articulated policies and stated clearly in the insolvency law, as recommended throughout the *UNCITRAL Legislative Guide on Insolvency Law* (hereinafter referred to as “the *UNCITRAL Insolvency Guide*”), adopted by UNCITRAL on 25 June 2004.¹

5. The effects of insolvency proceedings on security rights are discussed in detail, as a matter of insolvency law, in the *UNCITRAL Insolvency Guide*. The purpose of the present chapter is to highlight some of the key points of intersection between an insolvency law and a secured transactions law. The chapter discusses, in section A.3, the general principles concerning security rights in insolvency. Section A.4 reviews the law applicable in insolvency, while section A.5 elaborates upon the treatment of encumbered assets. Section A.6 considers post-commencement finance, section A.7, the treatment of contracts, and section A.8, avoidance proceedings. The next three sections deal with the participation of secured creditors in insolvency proceedings (section A.9), reorganization proceedings (section A.10) and expedited reorganization proceedings (section A.11). The last four sections address the treatment of secured claims (section A.12), the ranking of secured claims (section A.13), acquisition finance (section A.14) and receivables subject to an outright transfer before commencement (section A.15).

6. To provide a sufficient discussion of the effects of insolvency proceedings on security rights in this Guide, core recommendations from the *UNCITRAL Insolvency Guide* that relate particularly to security rights are included in this chapter. For a more complete discussion, however, this chapter should be read together with both the commentary and the recommendations of the *UNCITRAL Insolvency Guide*. This chapter also includes discussion of some additional recommendations elaborating on issues discussed in the *UNCITRAL Insolvency Guide*, but not the subject of recommendations in that Guide. The recommendations from the *UNCITRAL Insolvency Guide* are set out in section B.1 of the present chapter, and the additional recommendations are set out in section B.2.

2. Terminology

7. The *UNCITRAL Insolvency Guide* and the present Guide use a number of defined terms (see *UNCITRAL Insolvency Guide*, Introduction, section B, Glossary, and this Guide, Introduction, section B, Terminology). In addition to the recommendations referred to above, section B.1 of this chapter also includes certain

¹ For the decision of the United Nations Commission on International Trade Law and the resolution of the General Assembly (resolution 59/40 of 2 December 2004), see the *UNCITRAL Legislative Guide on Insolvency Law* (United Nations publication, Sales No. E.05.V.10), annex II. The *UNCITRAL Insolvency Guide*, which includes in its annex III the UNCITRAL Model Law on Cross-Border Insolvency and its Guide to Enactment, can be found at www.uncitral.org/uncitral/en/uncitral_texts/insolvency/2004Guide.html.

definitions from the *UNCITRAL Insolvency Guide* that facilitate understanding of the recommendations of that Guide.

8. Certain terms that are defined in the *UNCITRAL Insolvency Guide* are not redefined in this Guide and thus have the same meaning as in the *UNCITRAL Insolvency Guide*. Other terms, however, have been either slightly reworded or redefined in this Guide and therefore have a different meaning in this chapter, as indicated below.

9. The term “security right” is defined in this Guide. As used in this chapter it is not a synonym for “security interest” as defined in the *UNCITRAL Insolvency Guide*. The term “security interest” is broader in that it refers generally to “a right in an asset to secure payment or other performance of one or more obligations” and accordingly potentially covers security rights in immovable property (which are outside the scope of this Guide; see recommendation 5) and non-consensual security rights (which are not covered by the definition of “security right” in this Guide; see Introduction, section B, Terminology).

10. Similarly, the term “priority” is used in this chapter as defined in this Guide and not as defined in the *UNCITRAL Insolvency Guide*. The definition of “priority” in the *UNCITRAL Insolvency Guide* is narrower, referring only to the priority of claims in the context of insolvency (“the right of a claim to rank ahead of another claim where that right arises by operation of law”; see section B.1 below). This Guide defines “priority” as “the right of a person to derive the economic benefit of its security right in an encumbered asset in preference to a competing claimant” (see Introduction, section B, Terminology). To refer to “priority” in insolvency proceedings, this chapter uses the term “ranking of claims” (see, for example, paras. 59-63 below).

11. The term “debtor” is defined in this Guide by reference to the person owing the secured obligation. As that definition would not work well in the present chapter, “debtor” in this chapter has the meaning given to the term in the *UNCITRAL Insolvency Guide*, that is, a person that meets the requirements for the commencement of insolvency proceedings (see *UNCITRAL Insolvency Guide*, part two, chapter I, paras. 1-11 and recommendation 8).

12. In addition, as other chapters of this Guide focus on the term “grantor” (i.e. the person that creates a security right) rather than the term “debtor” (i.e. the person owing the secured obligation), references in this chapter to “debtor” should be understood as referring to situations where the grantor is the debtor in the insolvency proceedings.

3. General principles concerning security rights in insolvency

13. The *UNCITRAL Insolvency Guide* recognizes in principle the creation, third-party effectiveness, enforceability (see recommendation 4 of the *UNCITRAL Insolvency Guide*) and priority (see recommendation 1 of the *UNCITRAL Insolvency Guide*) of a security right as established under law other than the insolvency law (see recommendations 235 and 236 of this Guide). However, to achieve the goals of insolvency proceedings, the rights that a secured creditor has outside of insolvency proceedings may need to be modified or affected once the insolvency proceedings commence. In such a case, it is desirable that an insolvency law also include appropriate protections for the secured creditor. As noted throughout the *UNCITRAL*

Insolvency Guide, what is important for the availability of secured credit is that insolvency law contains clear rules as to the effect of insolvency proceedings on the rights of a secured creditor, so as to enable secured creditors to quantify the risks associated with insolvency and incorporate those risks into their assessment of whether to extend credit and on what terms.

4. Applicable law in insolvency proceedings

14. The determination of the law applicable to the creation, third-party effectiveness and priority of a security right and the post-default rights of a secured creditor may be a complex issue when insolvency proceedings are commenced in one State and some of the debtor's assets or creditors are located in another State, or when insolvency proceedings are commenced in two different States owing to the multinational nature of the debtor's business. In either instance, general conflict-of-laws rules applying outside of insolvency proceedings would govern these matters, subject to the limitations discussed in sections (a) and (b) below and the application of avoidance provisions of the insolvency law (see recommendation 220 of this Guide). This result is made clear in recommendation 30 of the *UNCITRAL Insolvency Guide*, which provides that the State in which insolvency proceedings are commenced (i.e. the forum State) should apply its conflict-of-laws rules to determine which State's law governs such questions as the creation and third-party effectiveness of a security right existing at the time of the commencement of insolvency proceedings.

(a) Insolvency effects: *lex fori concursus*

15. Once, under the non-insolvency law applicable outside of insolvency proceedings by virtue of the conflict-of-laws rules of the forum State, the creation and third-party effectiveness of a security right are determined, a second issue arises concerning the effect of commencement of insolvency proceedings on security rights. Points that need to be addressed are, for example, whether enforcement of a security right is stayed and whether the security right will be recognized in the insolvency proceedings and, if so, its relative position. It is generally recognized that the insolvency law of the State in which the insolvency proceedings are commenced (*lex fori concursus*) governs the commencement, conduct, including the ranking of claims, administration and conclusion of the proceedings (the "insolvency effects"; see recommendation 31 of the *UNCITRAL Insolvency Guide*).

16. The insolvency law governing the ranking of the security right may change the relative priority that a security right would have under secured transactions law, and establish categories of claims that would receive distributions ahead of a security right in insolvency proceedings. When establishing these categories of claims, reference should be made to secured transactions law with regard to the creation, third-party effectiveness, priority and enforcement of the security right before considering the extent, if any, to which the priority of the security right should be affected by the commencement and administration of insolvency proceedings. Irrespective of issues of ranking of rights, a security right might nevertheless be subject to the avoidance provisions of the insolvency law (see recommendation 88 of the *UNCITRAL Insolvency Guide*).

(b) Exceptions to the *lex fori concursus*

17. While the insolvency effects of insolvency proceedings on security rights typically are governed by the *lex fori concursus*, some States have adopted exceptions. For example, a forum State may defer to the insolvency law of the State in which immovable property is located (*lex situs* or *lex rei sitae*) for the insolvency effects on a security right in attachments to the immovable property. The *UNCITRAL Insolvency Guide* addresses these exceptions in more detail (see part two, chapter I, paras. 85-90 of that Guide), but does not recommend the adoption of a *lex rei sitae* rule for insolvency effects as applied to attachments to immovable property or even to movable property in general. Instead, it generally recommends that any exceptions to the applicability of the *lex fori concursus* for insolvency effects should be limited in number and clearly set forth in the insolvency law (see *UNCITRAL Insolvency Guide*, recommendation 34 and part two, chapter I, para. 88).

5. Treatment of encumbered assets

18. A security right may be affected following the commencement of insolvency proceedings by the provisions of insolvency law that define the scope of or otherwise address several matters. Such matters include, for example: the assets of the debtor that are subject to the insolvency proceedings; application of a stay or suspension of actions against the debtor; post-commencement finance; avoidance of transactions that took place before commencement of the proceedings; approval of a reorganization plan; and ranking of claims.

(a) Identification of assets subject to the proceedings

19. Identification of assets of the debtor that will be subject to insolvency proceedings is key to the successful conduct of the proceedings. Assets that are controlled by an insolvency representative and subject to the insolvency proceedings form the “estate” (see definition of the term “assets of the debtor” in section B.1 below). So, the *UNCITRAL Insolvency Guide* recommends that the estate formed on commencement of the proceedings will typically include all property, rights and interests of the debtor, including rights and interests in property, whether tangible (movable or immovable) or intangible, wherever located (domestic or foreign), and whether or not in the possession of the debtor at the time of commencement. The debtor’s rights and interests in encumbered assets and in third-party-owned assets, as well as assets acquired by the debtor or the insolvency representative after commencement of the proceedings and assets recovered through avoidance actions, should also be included in the estate (see *UNCITRAL Insolvency Guide*, recommendation 35).

(i) Encumbered assets

20. The inclusion in the estate of the debtor’s rights and interests in encumbered assets may assist in ensuring not only the equal treatment of creditors similarly situated, but also the achievement of the goals of the insolvency proceedings where, for example, the asset in question is essential for the reorganization of the debtor or sale of the debtor’s business as a going concern in liquidation. The *UNCITRAL Insolvency Guide* discusses the assets of the debtor to be included in the estate (as well as those assets to be excluded) and the effect of commencement of

insolvency proceedings on encumbered assets. It emphasizes, in particular, the importance to a successful reorganization of including in the insolvency estate the debtor's interest in encumbered assets and third-party-owned assets (for the definition of the term "assets of the debtor", see section B.1 below; for a discussion of the estate, see *UNCITRAL Insolvency Guide*, part two, chapter II, paras. 7-9) and of applying a stay on commencement to certain actions with respect to security rights (see *UNCITRAL Insolvency Guide*, part two, chapter II, paras. 36-40, 56, 57 and 59-69 and recommendation 46, as well as paras. 26 and 27 below).

(ii) *Assets acquired after commencement of insolvency proceedings*

21. The *UNCITRAL Insolvency Guide* (see recommendation 35, subparagraph (b)), provides that an asset acquired by the debtor after the commencement of insolvency proceedings generally is part of the insolvency estate.

22. Accordingly, even though the secured creditor may have a security right in future assets of the debtor, the security right should not extend to assets acquired by the debtor after the commencement of the insolvency proceedings (see also recommendation 232 of this Guide), unless the secured creditor is providing additional funding. If the security right did extend generally to assets acquired by the debtor after the commencement of the insolvency proceedings, the secured creditor would unfairly benefit from the increase in the encumbered assets that could be available to satisfy the secured obligation resulting from the post-commencement acquisition of assets by the debtor without the secured creditor providing any additional credit to the debtor. Likewise, other creditors of the insolvency estate would be unfairly prejudiced if unencumbered assets of the insolvency estate were used after the commencement of the insolvency proceedings to acquire additional assets and those assets were to become automatically subject to the secured creditor's security right and used to satisfy the secured obligation.

23. However, if the assets acquired by the debtor after the commencement of the insolvency proceedings consist of proceeds of assets in which a secured creditor had a security right that was effective against third parties before the commencement of the insolvency proceedings (or was made effective against third parties after commencement but within any applicable grace period), the security right should extend to the proceeds (see recommendation 233 of this Guide). If this were not the case, the secured creditor would not have the benefit of its security right in an encumbered asset that is disposed of or collected after the commencement of the insolvency proceedings and, because of that risk, would be less willing to extend credit to the debtor even where there is no prospect of the commencement of the debtor's insolvency proceedings.

24. An example may be helpful in illustrating these points. A secured creditor has an unavoidable security right in the debtor's entire existing and future inventory. After the commencement of insolvency proceedings, the debtor sells immovable property that is not subject to any security right and uses the cash received from the sale to buy inventory. The security right should not extend to this post-commencement inventory. The secured creditor advanced no credit in reliance upon a security right in the new inventory. Permitting the security right to extend to the new inventory would prejudice other creditors of the insolvency estate since the immovable property, an unencumbered asset that was otherwise available to satisfy

claims of the other creditors, would have been used to increase the assets available to satisfy the secured obligation.

25. By contrast, if the additional inventory was acquired with cash received by the debtor from the sale of inventory existing on the commencement of the insolvency proceedings and in which the secured creditor had an unavoidable security right, the security right should extend to the inventory acquired after the commencement of the insolvency proceedings. The additional inventory is in effect a substitution for the sold inventory. The secured creditor does not benefit unfairly and other creditors are not unfairly prejudiced.

(b) Protection of the estate by application of a stay

26. Two essential objectives of an effective insolvency law are, first, ensuring that the value of the insolvency estate is not diminished by the actions of various parties and, second, facilitating administration of the estate in a fair and orderly manner (see *UNCITRAL Insolvency Guide*, recommendation 1). Many insolvency laws achieve these objectives by imposing a stay that prevents the commencement of individual or group actions by creditors to enforce their claims or pursue any remedies or proceedings against the debtor or property of the estate and suspends any such actions already under way. Where the stay applies from the commencement of the insolvency proceedings (see *UNCITRAL Insolvency Guide*, recommendation 46), it can be complemented by provisional measures of relief that can be ordered by the court to ensure protection of the assets of the debtor and the collective interest of creditors between the time when an application to commence insolvency proceedings has been filed and the time it is acted on by the court (see *UNCITRAL Insolvency Guide*, recommendations 39-45). The *UNCITRAL Insolvency Guide* discusses the scope of actions to which a mandatory or provisional stay applies (see *UNCITRAL Insolvency Guide*, part two, chapter II, paras. 30-40); time and duration (including extension) of the stay (see part two, chapter II, paras. 41-53 and 58); and measures to protect the interests of secured creditors (part two, chapter II, paras. 59-69; see also *UNCITRAL Insolvency Guide*, recommendations 39-51).

(i) Scope of the stay

27. A number of States extend the stay to all actions against the debtor, whether judicial or not, including those by secured creditors and third-party owners. The stay usually extends to actions to enforce a security right by repossessing and selling, leasing or otherwise disposing of the encumbered assets (or exercising another enforcement remedy set out in chapter X, Enforcement of a security right, of this Guide). It also extends to actions to create a security right or to make a security right effective against third parties (see *UNCITRAL Insolvency Guide*, recommendation 46). Some insolvency laws distinguish between liquidation and reorganization in terms of application and duration of the stay to actions by secured creditors or third-party owners. A growing number of insolvency laws recognize that, notwithstanding that limiting the enforcement of security rights may have an adverse impact on the cost and availability of credit, excluding actions by secured creditors from the stay could frustrate the basic objectives of the insolvency proceedings. This is true particularly in reorganization, since very often the debtor's continued use of encumbered assets is essential to the operation of the business and

therefore to its reorganization. Any negative effects of the stay can be ameliorated by measures to ensure that the economic value of the encumbered assets is protected against diminution (see paras. 31-34 below).

28. Where a security right was effective against third parties at the time the insolvency proceedings commenced, it is necessary to exempt from the application of the stay any action that the secured creditor might need to take to ensure that effectiveness continues. For example, the secured transactions law may provide a grace period for registration of certain security rights, such as acquisition security rights, in the general security rights registry (see recommendations 176 and 189 of this Guide); the stay generally should not interfere with registration within such a grace period (even if the grace period ends after the commencement of the insolvency proceedings).

(ii) *Duration of the stay*

29. In reorganization proceedings, subject to the safeguards discussed below, it is desirable that the stay apply to security rights for a sufficient period of time to ensure orderly administration of the reorganization without encumbered assets being removed from the estate before it can be determined how those assets should be treated and an appropriate plan approved.

30. It is also desirable that the stay apply to security rights in liquidation proceedings, in particular to facilitate sale of the business as a going concern. The *UNCITRAL Insolvency Guide* recommends that the stay should apply for a short period of time (e.g. 30-60 days) that is clearly set forth in the insolvency law, with provision for the court to provide an extension in certain limited circumstances (see *UNCITRAL Insolvency Guide*, recommendation 49).

(iii) *Protection of secured creditors*

31. An insolvency law should include safeguards to protect secured creditors where the economic value of their security rights is adversely affected by the stay (see *UNCITRAL Insolvency Guide*, recommendation 50). One of those safeguards may take the form of relief from the stay or a release of the encumbered asset. Even absent a request for relief from the stay, it is desirable that an insolvency law provide that a secured creditor is entitled to protection against the diminution in value of the encumbered asset and that the court may grant appropriate measures to ensure that protection.

32. The *UNCITRAL Insolvency Guide* recommends that grounds for relief from the stay or release of the encumbered asset might include cases where, for example, the encumbered asset is not necessary to a prospective reorganization or sale of the debtor's business; the value of the encumbered asset is diminishing as a result of the commencement of the insolvency proceedings and the secured creditor is not protected against that diminution of value; and, in reorganization, a plan is not approved within any applicable time limit (see *UNCITRAL Insolvency Guide*, recommendation 51). Some insolvency laws also provide that, once relief has been granted and the stay has been lifted with respect to a particular encumbered asset, the asset may be released to the secured creditor. In such an event, the secured creditor would be free to enforce its security right against such asset under

applicable law. Any surplus value remaining after payment of the secured obligation would be part of the estate.

33. Central to the notion of protecting the value of encumbered assets from diminution is the mechanism for determining both the value of those assets and the time at which valuation takes place, depending upon the purpose for which the determination is required. Assets may need to be valued at different times during the insolvency proceedings, such as at commencement with the value being reviewed during the proceedings, or during the course of the proceedings. The basis on which the valuation should be made is also an issue (e.g. going concern or liquidation value). The value of an encumbered asset may, at least in the first instance, be determined by pre-commencement agreement of the parties or may require determination by the court on the basis of evidence, including a consideration of markets, market conditions and expert testimony.

34. The *UNCITRAL Insolvency Guide* discusses the timing of valuation and different valuation mechanisms (see *UNCITRAL Insolvency Guide*, part two, chapter II, paras. 66-68).

(c) Use and disposal of encumbered assets

35. Secured creditors will have an ongoing concern with the manner in which encumbered assets are treated following commencement of insolvency proceedings. Treatment of these assets will depend on the provisions of the insolvency law with respect, for example, to application of the stay, further encumbrance of those assets, use of the assets during the course of the insolvency proceedings, sale or disposal of assets, relinquishment of assets and sale of encumbered assets free and clear of any security rights.

36. The *UNCITRAL Insolvency Guide* recommends that the insolvency law should permit encumbered assets to be used and disposed of or further encumbered in the insolvency proceedings. It sets out recommendations about the conditions under which encumbered assets may be sold free of security rights (for example, the condition that the security right in an asset extends to the proceeds of the sale of the asset) and the protections to be afforded to secured creditors whose encumbered assets are so sold, including the need to notify secured creditors about any proposed sale or other disposal of encumbered assets and to give them an opportunity to object (see *UNCITRAL Insolvency Guide*, part two, chapter II, paras. 74-89 and recommendations 52-59).

6. Post-commencement finance

37. In both liquidation and reorganization proceedings, an insolvency representative may require access to funds to continue to operate the business. The estate may have insufficient liquid assets to fund anticipated expenses, in the form of cash or other assets that will be converted to cash (such as anticipated proceeds of receivables) and that are not subject to pre-existing security rights effective against third parties. Where there are insufficient unencumbered liquid assets or anticipated cash flow, the insolvency representative must seek financing from third parties. Often, these parties are the same lenders that extended credit to the debtor prior to the commencement of insolvency proceedings, and typically they will only be willing to extend the necessary credit if they receive appropriate

assurance (either in the form of a priority claim on, or priority security rights in, the assets of the estate) that they will be repaid.

38. In any of these financing arrangements (referred to collectively as “post-commencement finance”), it is essential that the rights of pre-commencement secured creditors in the economic value of the encumbered assets be appropriately protected against diminution. While some States permit, in limited circumstances, the creation of a security right to secure post-commencement finance that ranks ahead of a pre-existing security right, the *UNCITRAL Insolvency Guide* recommends that the creation of such a security right (sometimes referred to as a “priming lien”) should be permitted only where certain conditions are met, including that the rights of pre-commencement secured creditors in the economic value of the encumbered assets are protected against diminution. Post-commencement finance is addressed in some detail in part two, chapter II, paras. 94-107 and recommendations 63-68, of the *UNCITRAL Insolvency Guide*.

7. Treatment of contracts

(a) Automatic termination or acceleration clauses

39. Parties to security agreements have an interest in the treatment in insolvency of clauses that define events of default giving rise to automatic termination or acceleration of payments under the agreement. Although some insolvency laws permit those clauses to be overridden when insolvency proceedings commence, this approach has not yet become a general feature of insolvency laws. The inability to interfere with general principles of contract law in this way, however, may make reorganization impossible where the contract relates, for example, to an asset that is necessary for reorganization or the sale of a business as a going concern. The *UNCITRAL Insolvency Guide* recommends that such clauses should be unenforceable as against the insolvency representative and the debtor (see *UNCITRAL Insolvency Guide*, recommendation 70).

40. Any negative impact of a policy of overriding these types of clause can be balanced by providing compensation to creditors that can demonstrate that they have suffered damage or loss as a result of a contract continuing to be performed after commencement of insolvency proceedings or providing an exception to a general override of such clauses for certain types of contract. The *UNCITRAL Insolvency Guide* recommends that the contracts excepted from a general override might include financial contracts and that special rules might be required in the case of labour contracts (see *UNCITRAL Insolvency Guide*, recommendations 70 and 71).

41. The insolvency law could also provide, for example, that such a clause does not render unenforceable or invalidate a contract clause relieving a creditor from an obligation to make a loan or otherwise extend credit or other financial accommodations for the benefit of the debtor after the commencement of the insolvency proceedings. It would not be equitable to require a lender to make loans or other extensions of credit to an insolvent party where the prospect of repayment would be greatly diminished. Requiring the extension of credit after commencement of insolvency proceedings would be especially inequitable if, as described in paragraph 22 above, no additional encumbered assets are being provided after commencement to the secured creditor (see recommendation 234 of this Guide).

(b) Continuation or rejection of contracts

42. Insolvency laws adopt different approaches to continued performance or rejection of contracts. The *UNCITRAL Insolvency Guide* makes a number of recommendations relating to the handling of contracts once insolvency proceedings commence. These include recommendations about the procedures for determining whether contracts should continue to be performed or rejected, the treatment of contracts where the debtor is in default on commencement of insolvency proceedings, effects of continuing performance or rejection, leases, assignment of contracts, types of contract for which exceptions might be required and post-commencement contracts (see *UNCITRAL Insolvency Guide*, part two, chapter II, paras. 108-147 and recommendations 69-86). In any case, what is important for a secured creditor is that rejection of a security agreement does not terminate or otherwise impair the secured obligations already incurred or extinguish the security right and that financial contracts and loan commitments are frequently excepted from the scope of insolvency laws governing the treatment of contracts more generally (see *UNCITRAL Insolvency Guide*, part two, chapter II, paras. 208-215 and recommendation 101).

8. Avoidance proceedings

43. As mentioned above, insolvency law should recognize in principle the effectiveness of a security right that is effective as a matter of secured transactions law. Nevertheless, the security right may be avoidable in insolvency proceedings on the same grounds as any other transaction. For example, the transaction may be avoided as a preferential transaction, an undervalued transaction, or as a transaction intended to defeat, hinder or delay creditors from collecting their claims (see *UNCITRAL Insolvency Guide*, recommendation 87). Thus, were the debtor to encumber its assets to prefer one creditor to another on the eve of the commencement of insolvency proceedings, or without obtaining corresponding value, to the detriment of other creditors, the transaction may be avoided as a preferential or undervalued transaction. The *UNCITRAL Insolvency Guide* discusses categories of transactions subject to avoidance, the suspect period, conduct of avoidance proceedings and liability of counterparties to avoided transactions (see part two, chapter II, paras. 148-203 and recommendations 87-99 of that Guide).

44. Examples of security rights that may be subject to avoidance include a security right created shortly before the commencement of insolvency proceedings to secure a pre-existing debt; a security right with respect to which one or more of the steps required to make it effective as against third parties have been taken after the creation of the security right, and after the expiry of any grace period for doing so (see recommendations 176 and 189 of this Guide) but within the suspect period; and the acquisition of an encumbered asset by the secured creditor in total or partial satisfaction of the secured obligation (see recommendations 153-156 of this Guide) at a price significantly lower than the asset's actual value.

9. Participation of secured creditors in insolvency proceedings

45. Where encumbered assets are part of the insolvency estate and the rights of secured creditors are affected by insolvency proceedings, secured creditors should be entitled to participate in the insolvency proceedings (see *UNCITRAL Insolvency Guide*, recommendation 126). That participation may take different forms.

Under some laws it includes the right to be heard and to appear in the proceedings, while under other laws, it includes the right to vote on certain specified matters, such as selection (and removal) of the insolvency representative and approval of a reorganization plan, to provide advice to the insolvency representative as requested or on matters specified in the insolvency law, and other functions and duties as determined by the insolvency law, the courts or the insolvency representative. In some cases, the extent of a secured creditor's right to vote on certain issues may depend upon whether the secured obligation exceeds the value of the encumbered assets; if the secured creditor is under-secured, it might participate as an unsecured creditor to the extent that its obligation is not satisfied from the encumbered asset.

46. The *UNCITRAL Insolvency Guide* discusses issues of participation of creditors generally and mechanisms that may be used to facilitate that participation (see part two, chapter III, paras. 75-115 and recommendations 126-137).

10. Reorganization proceedings

(a) Approval of a reorganization plan

47. Whether or not a secured creditor is entitled to participate in the approval of a reorganization plan will depend upon the manner in which the insolvency law treats secured creditors and, in particular, the extent to which a reorganization plan can modify or impair their security rights and the extent to which the value of the encumbered asset will satisfy the secured creditor's claim. Where the value of the encumbered asset is not sufficient to satisfy the secured creditor's claim, the creditor may participate both as a secured and an unsecured creditor.

48. Where a reorganization plan proposes to impair or modify the rights of secured creditors, they should have the opportunity to vote on approval of that plan (see *UNCITRAL Insolvency Guide*, recommendation 146). For that purpose, some insolvency laws classify creditors, including secured creditors, according to the nature of their rights and interests. Under some laws, secured creditors vote together as a class separate from unsecured creditors. Under other laws, each secured creditor forms a class of its own.

49. Where secured creditors participate in the approval process, there is a question of whether they are bound by the plan even if they vote against it or abstain from voting. Where secured creditors vote in classes, some insolvency laws provide that, to the extent that the requisite majority of the class votes to approve the plan, dissenting members of the class are bound by the plan, subject to certain protections (e.g. they receive at least as much under the plan as they would have received in a liquidation or they are paid in full within a certain period of time with interest at a market rate). The *UNCITRAL Insolvency Guide* discusses reorganization proceedings in some detail (see *UNCITRAL Insolvency Guide*, part two, chapter IV, paras. 26-75 and recommendations 139-159), including voting by secured creditors (see *UNCITRAL Insolvency Guide*, part two, chapter IV, paras. 34-39 and recommendations 146, 150 and 151).

50. There are several examples of ways in which the economic value of security rights may be preserved in a reorganization plan even though the security rights are being impaired or modified by that plan. If a plan provides for a cash payment to a secured creditor in total or partial satisfaction of the secured obligation, the cash payment or, if cash payments are to be made in instalments, the present value of the

cash payments, should not be less than what the secured creditor would have received in liquidation. In determining such value, consideration should be given to the use of the assets and the purpose of the valuation. The basis of such a valuation may include not only the strict liquidation value, but also the value of the asset as part of the business as a going concern. For example, if the debtor is going to retain possession of and continue to use the asset under the reorganization plan in order to continue to operate the business as a going concern or if the debtor is going to sell the business as a going concern, this value should be determined by reference to the value of the asset as part of the going concern business rather than the value of the asset as a single item separate from the business.

51. If the plan provides for the secured creditor to release its security right in some encumbered assets, provision could also be made for substitute assets of at least equal value to become subject to the secured creditor's security right, unless disposal of the remaining encumbered assets would enable the secured creditor to be paid in full.

(b) Valuation of encumbered assets

52. Recommendations 49, subparagraph (c) (ii), 50, 51, subparagraph (b), 54, subparagraph (a), 58, subparagraph (d), 59, subparagraph (c), and 67, subparagraph (c), of the *UNCITRAL Insolvency Guide* provide generally for the value of encumbered assets to be protected in insolvency proceedings. Recommendation 152, subparagraph (b), of the *UNCITRAL Insolvency Guide* provides that, under a plan confirmed by a court, all creditors, including secured creditors, should receive at least as much under the plan as they would have received in liquidation. Issues to be considered in determining the value of encumbered assets are discussed in the *UNCITRAL Insolvency Guide* (see part two, chapter II, paras. 66-69, of that Guide and para. 33 above).

53. In order to determine the liquidation value of encumbered assets in reorganization proceedings (for the purpose of applying recommendation 152, subparagraph (b), of the *UNCITRAL Insolvency Guide*), the use of the encumbered assets, the purpose of the valuation and other relevant considerations should be taken into account. The liquidation value of the assets, for example, may be based on their value as part of a going concern (see recommendation 239 of this Guide), which may better represent a more accurate value of the encumbered assets given the purposes for which they are to be used.

11. Expedited reorganization proceedings

54. In recent years, significant attention has been given to the development of expedited reorganization proceedings (i.e. proceedings commenced to give effect to a plan negotiated and agreed to by affected creditors in voluntary restructuring negotiations that took place prior to commencement of insolvency proceedings, where the insolvency law permits the court to expedite the conduct of those proceedings). Voluntary restructuring negotiations undertaken before the commencement of proceedings will generally involve those creditors, including secured creditors, whose participation is required to ensure an effective reorganization or whose rights are to be affected by the reorganization.

55. The substantive requirements for such expedited reorganization proceedings would include substantially the same safeguards and protections as provided in full, court-supervised reorganization proceedings. However, since the reorganization plan has already been negotiated and agreed to by the requisite majority of creditors at the time the expedited proceedings commence, a number of the procedural provisions of an insolvency law relating to full court-supervised proceedings may be modified or need not apply (see *UNCITRAL Insolvency Guide*, part two, chapter IV, paras. 87-92 and recommendations 160-168).

12. Treatment of secured claims

56. An important issue for secured creditors is whether they will be required to submit their claims in the insolvency proceedings. Under those insolvency laws that do not include encumbered assets in the insolvency estate and allow secured creditors freely to enforce their security rights against the encumbered assets, secured creditors may be excepted from the requirement to submit a claim. In such cases, they need to file a claim only to the extent that their claim has not been fully met from the value of the sale of the encumbered asset (see *UNCITRAL Insolvency Guide*, part two, chapter V, paras. 1-50 and recommendations 169-184).

57. Another approach requires secured creditors to submit a claim for the total value of their security rights irrespective of whether any part of the claim is unsecured. That requirement is limited in some laws to the holders of certain types of security right, such as floating charges, bills of sale, or security over chattels. Some insolvency laws also permit secured creditors to surrender their security rights to the insolvency representative and submit a claim for the total value of the secured obligation. The rationale of requiring secured creditors to submit claims is to provide information to the insolvency representative as to the existence of all claims, the amount of the secured obligation and the description of the encumbered assets. Whichever approach is chosen, it is desirable that an insolvency law include clear rules on the treatment of secured creditors for the purposes of submission of claims.

58. Where the amount of the claim cannot be, or has not been, determined at the time when the claim is to be submitted, many insolvency laws allow a claim to be admitted provisionally, subject to giving it a notional value (see *UNCITRAL Insolvency Guide*, recommendation 178). Determining a value for such claims raises a number of issues such as the time at which the value is to be determined and whether it must be liquidated (in which case it will need to be considered by a court) or estimated (which might be undertaken by the insolvency representative, the court or some other appointed person) (see *UNCITRAL Insolvency Guide*, recommendation 179). Where a court is required to determine the issue, an associated question relates to the court that will be appropriate (i.e. the insolvency court or some other court) and how any delay in reaching a determination can be addressed in terms of its effect on the conduct of the insolvency proceedings. As to timing, many insolvency laws require the valuation to refer to the effective date of commencement of proceedings (see *UNCITRAL Insolvency Guide*, part two, chapter V, para. 38 and recommendation 179).

13. Ranking of secured claims

59. A secured transactions law establishes the priority of security rights as against competing claimants (for the definition of the terms “competing claimant” and “priority”, see Introduction, section B, Terminology, of this Guide), including other secured and unsecured creditors of a debtor, judgement creditors with a right in encumbered assets and buyers of encumbered assets. Many insolvency laws recognize the pre-insolvency priority of security rights and rank those rights ahead of other claims, such as administration expenses and other claims (e.g. for taxes or wages). Such laws provide that secured claims should be satisfied from the proceeds of sale of the specific encumbered assets or from general funds, depending upon the manner in which the encumbered assets are treated in the insolvency (see *UNCITRAL Insolvency Guide*, recommendation 188). However, where the insolvency representative has expended unencumbered resources of the estate in maintaining or preserving the value of the encumbered assets, those expenses may be given a higher ranking even over a secured claim. Accordingly, they may have to be paid out of the proceeds from the sale of or other value attributable to the encumbered assets (see recommendation 238 of this Guide).

60. Other insolvency laws rank secured claims after administration costs and other specified (and generally unsecured) claims (e.g. for wages or taxes) or limit the amount with respect to which a secured claim will be given a higher ranking to a fixed percentage of the claim. The higher ranking given to certain unsecured claims, which is often based on social policy considerations, has an impact upon the cost and availability of secured credit. The approach of restricting the amount recovered by a secured creditor from the value of the encumbered assets is sometimes taken with respect to a security right in the entirety of a debtor’s assets in order to provide some protection to unsecured creditors (often up to a limited amount).

61. A further approach may permit the ranking of post-commencement secured creditors ahead of the rights of secured creditors existing at the time of commencement (see paras. 37 and 38 above), provided the security rights of pre-existing creditors can be protected (see *UNCITRAL Insolvency Guide*, recommendations 66 and 67).

62. It is desirable that situations in which an insolvency law creates special privileges for certain types of claim ranking ahead of security rights (for example, a privilege for payment of tax or other unsecured claims), those privileges be kept to a minimum and clearly stated or referred to in the insolvency law (see recommendation 80 of this Guide). This approach will ensure that the insolvency regime is transparent and predictable as to its impact on creditors and will enable secured creditors to assess more accurately the risks associated with extending credit. These issues are discussed in more detail in the *UNCITRAL Insolvency Guide*, part two, chapter V, paragraphs 51-79 and recommendations 185-193.

63. As already mentioned, insolvency law usually respects the pre-commencement priority of a security right (where the security right was made effective against third parties prior to commencement or after commencement but within a grace period), subject to any privileges for other claims that may be introduced by insolvency law. The same applies to priority of security rights established by subordination (i.e. a change of priority of a security right by agreement, by order of a court or even

unilaterally; see recommendation 237 of this Guide). However, subordination should not result in a secured creditor being accorded a ranking higher than its ranking, whether as an individual creditor or as a member of a class of secured creditors, under applicable law. This means that, if secured creditors A, B and C rank in priority so that A is first, B is second and C is third, and A subordinates its secured claim to that of C, B does not obtain a ranking higher than A would have had with respect to the amount of A's claim. It also means that a secured creditor obtaining a subordination from a secured creditor within a class cannot obtain a ranking higher than the ranking of the class.

14. Acquisition financing transactions

64. The treatment in insolvency of security rights and other rights that function so as to secure the performance of an obligation is a key concern of a buyer's, lessee's or borrower's creditors. This treatment can sometimes vary according to how any particular right is characterized in a secured transactions law; the way in which they are treated in the secured transactions law will generally determine how they are treated in insolvency. Accordingly, the *UNCITRAL Insolvency Guide* does not address the issue of how these rights are characterized in secured transactions law and addresses only the treatment of such rights in insolvency, given their characterization by secured transactions law.

65. In States that integrate all forms of acquisition financing rights into their secured transactions law, retention-of-title transactions and financial leases are treated in the debtor's insolvency in the same way as a non-acquisition security right, with recognition given to any special priority status accorded to the acquisition security right under non-insolvency law (see recommendation 183, chapter XI, unitary approach to acquisition financing, of this Guide). The same result would occur whenever secured transactions law characterizes a transaction as giving rise to a security right (see recommendation 198, alternative A, chapter XI, non-unitary approach to acquisition financing, of this Guide). Accordingly, the provisions of the *UNCITRAL Insolvency Guide* applicable to security rights would apply to these various acquisition security rights. Where States maintain separately denominated retention-of-title and financial lease transactions, assets subject to these transactions are often not treated by secured transactions law as assets subject to a security right, but rather as assets owned by the seller or the lessor. Accordingly, the provisions of the *UNCITRAL Insolvency Guide* relating to third-party-owned assets would apply to these transactions (see recommendation 198, alternative B, chapter XI, non-unitary approach to acquisition financing, of this Guide).

66. In any case, regardless of whether an acquisition financing right is treated in the insolvency proceedings under the rules applicable to security rights or under the rules applicable to contracts and third-party-owned assets, all acquisition financing rights should be subject to the insolvency effects specified in the *UNCITRAL Insolvency Guide*. With either alternative of the non-unitary approach (see alternatives A and B of recommendation 198 of this Guide), it may be important to note that the *UNCITRAL Insolvency Guide* often recommends the same treatment for the holders of security rights and third-party-owned assets. This is the case, for example, with respect to recommendation 88 of the *UNCITRAL Insolvency Guide* (regarding the application of avoidance powers to, among other things,

security rights); recommendation 35 (regarding the inclusion of the debtor's rights in encumbered assets of the insolvency estate); recommendations 39-51 (regarding the application of provisional measures and a stay to encumbered assets and relief from the stay); recommendation 52 (regarding use and disposal of assets of the estate, including encumbered assets); recommendation 54 (regarding the use of third-party-owned assets); and recommendations 69-86 (regarding the treatment of contracts).

15. Receivables subject to an outright transfer before commencement

67. An outright transfer of a receivable is within the scope of the present Guide although such a transfer is not made for the purpose of securing the performance of an obligation (see recommendations 3 and 164 of this Guide). In any case, irrespective of how it is treated by non-insolvency law, insolvency law treats an outright transfer of a receivable as any other pre-commencement transfer of an asset by the debtor (see generally *UNCITRAL Insolvency Guide*, recommendation 35, subparagraph (a)).

B. Recommendations

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

II. PROCUREMENT

A. Report of the Working Group on Procurement on the work of its tenth session (Vienna, 25-29 September 2006)

(A/CN.9/615) [Original: English]

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I. Introduction

1. At its thirty-seventh session, in 2004, the United Nations Commission on International Trade Law (the “Commission”) entrusted the drafting of proposals for the revision of the 1994 UNCITRAL Model Law on Procurement of Goods, Construction and Services (the “Model Law”, A/49/17 and Corr.1, annex I) to its Working Group I (Procurement). The Working Group was given a flexible mandate to identify the issues to be addressed in its considerations, including providing for new practices in public procurement, in particular those that resulted from the use of electronic communications (A/59/17, para. 82). The Working Group began its work on the elaboration of proposals for the revision of the Model Law at its sixth session (Vienna, 30 August-3 September 2004) (A/CN.9/568). At that session, it decided to proceed at its future sessions with the in-depth consideration of topics in documents A/CN.9/WG.I/WP.31 and 32 in sequence (A/CN.9/568, para. 10).

2. At its seventh to ninth sessions (New York, 4-8 April 2005, Vienna, 7-11 November 2005, and New York, 24-28 April 2006, respectively) (A/CN.9/575, A/CN.9/590 and A/CN.9/595), the Working Group considered the topics related to: (a) the use of electronic means of communication in the procurement process, including exchange of communications by electronic means, the electronic submission of tenders, opening of tenders, holding meetings and storing information, as well as controls over their use; (b) aspects of the publication of procurement-related information, including possibly expanding the current scope of article 5 of the Model Law and referring to the publication of forthcoming procurement opportunities; and (c) electronic reverse auctions, including whether they should be treated as an optional phase in other procurement methods or a stand-alone method, criteria for their use, types of procurement to be covered, and their procedural aspects. At its seventh and eighth sessions, the Working Group in

addition considered the issues of abnormally low tenders, including their early identification in the procurement process and the prevention of negative consequences of such tenders. At its ninth session, the Working Group came to preliminary agreement on the draft revisions to the Model Law and the Guide that would be necessary to accommodate the use of electronic communications and technologies (including electronic reverse auctions) in the Model Law. It decided that at its tenth session it would proceed with further consideration of those draft revisions as well as with the in-depth consideration of the proposed revisions to the Model Law and the Guide addressing the remaining aspects of electronic reverse auctions and the investigation of abnormally low tenders, and, time permitting, would take up the topics of framework agreements and suppliers' lists (A/CN.9/595, para. 9).

3. At its thirty-eighth and thirty-ninth sessions, in 2005 and 2006, respectively, the Commission commended the Working Group for the progress made in its work and reaffirmed its support for the review being undertaken and for the inclusion of novel procurement practices in the Model Law (A/60/17, para. 172, and A/61/17, para. 191). At its thirty-ninth session, the Commission also recommended that the Working Group, in updating the Model Law and the Guide, should take into account issues of conflicts of interest and should consider whether any specific provisions addressing those issues would be warranted in the Model Law (A/61/17, para. 192).

II. Organization of the session

4. The Working Group, which was composed of all States members of the Commission, held its tenth session in Vienna from 25 to 29 September 2006. The session was attended by representatives of the following States members of the Working Group: Algeria, Argentina, Austria, Belarus, Brazil, Cameroon, Canada, Chile, China, Croatia, Czech Republic, France, Germany, Iran (Islamic Republic of), Italy, Kenya, Lithuania, Mexico, Nigeria, Pakistan, Republic of Korea, Russian Federation, Singapore, Spain, Sweden, Thailand, Turkey, Uganda, United Kingdom of Great Britain and Northern Ireland, United States of America and Venezuela (Bolivarian Republic of).

5. The session was attended by observers from the following States: Bulgaria, Democratic Republic of the Congo, Dominican Republic, Finland, Indonesia, Ireland, Latvia, Malaysia, Philippines, Romania, Slovakia and Timor-Leste.

6. The session was also attended by observers from the following international organizations:

(a) *United Nations system*: United Nations Office of Legal Affairs and the World Bank.

(b) *Intergovernmental organizations*: Asian Clearing Union (ACU), European Commission, European Space Agency (ESA), Inter-American Development Bank (IADB), and Organization for Economic Cooperation and Development (OECD).

(c) *International non-governmental organizations invited by the Working Group*: Centre for International Legal Studies (CILS), European Law Students Association (ELSA), International Bar Association (IBA), and International Chamber of Commerce (ICC).

7. The Working Group elected the following officers:
Chairman: Mr. Stephen R. KARANGIZI (Uganda)
Rapporteur: Sra. Ligia GONZÁLEZ LOZANO (Mexico)
8. The Working Group had before it the following documents:
 - (a) Annotated provisional agenda (A/CN.9/WG.I/WP.46 and Corr.1);
 - (b) A note concerning electronic reverse auctions and abnormally low tenders (A/CN.9/WG.I/WP.43 and Add.1);
 - (c) A comparative study of framework agreements (A/CN.9/WG.I/WP.44 and Add.1);
 - (d) A note concerning suppliers' lists (A/CN.9/WG.I/WP.45 and Add.1);
 - (e) A note concerning the use of electronic communications in the procurement process and the electronic publication of procurement-related information, including drafting materials (A/CN.9/WG.I/WP.47);
 - (f) A further note concerning electronic reverse auctions, including drafting materials (A/CN.9/WG.I/WP.48); and
 - (g) A note on legislative work of international organizations relating to public procurement (A/CN.9/598/Add.1).
9. The Working Group adopted the following agenda:
 1. Opening of the session.
 2. Election of officers.
 3. Adoption of the agenda.
 4. Consideration of proposals for the revision of the UNCITRAL Model Law on Procurement of Goods, Construction and Services.
 5. Other business.
 6. Adoption of the report of the Working Group.

III. Deliberations and decisions

10. At its tenth session, the Working Group continued its work on the elaboration of proposals for the revision of the Model Law. The Working Group used the notes by the Secretariat referred to in paragraph 8 above (WP.43 and 44 and their addenda, 47 and 48, and document A/CN.9/598/Add.1) as a basis for its deliberations. The Working Group agreed to defer the consideration of document A/CN.9/WG.I/WP.45 and Add.1 to a future session.
11. The Working Group requested the Secretariat to revise the drafting materials reflecting the deliberations at the tenth session, for its consideration at its next session. It also requested the Secretariat to prepare drafting materials for the Model Law and the Guide on the use of framework agreements. The Working Group agreed to add the issue of conflicts of interest to the list of topics to be considered in the revision of the Model Law and the Guide.

IV. Consideration of proposals for the revision of the UNCITRAL Model Law on Procurement of Goods, Construction and Services

A. General comments

1. Project timetable

12. The Working Group recalled the list of topics for its consideration in revising the Model Law, as follows: (a) electronic publication of procurement-related information; (b) the use of electronic communications in the procurement process; (c) controls over the use of electronic communications in the procurement process; (d) electronic reverse auctions (ERAs) and abnormally low tenders (ALTs); (e) the use of suppliers' lists; (f) framework agreements; (g) procurement of services; (h) evaluation and comparison of tenders, and the use of procurement to promote industrial, social and environmental policies; (i) remedies and enforcement; (j) alternative methods of procurement; (k) community participation in procurement; (l) simplification and standardization of the Model Law; (m) legalization of documents; and (n) conflicts of interest in the procurement process, a topic that the Commission referred to the Working Group to ensure that the Model Law complied with the requirements of the United Nations Convention against Corruption¹ in this regard (see para. 3 above and para. 85 below).

13. The Working Group expressed its desire to complete its work on those topics in 2008. In seeking to achieve that target, the Working Group noted that its first priority would be the preparation of the revised text of the Model Law itself.

2. Revisions to the Guide to Enactment

14. The Working Group noted that the Guide to Enactment could be addressed not just to legislators, but also to regulators and perhaps operators (procurement officials such as contracting officers and those in charge of designing electronic systems for use in procurement). Therefore, its guidance could contain provisions addressed to each group of users, including guiding principles for legislators, regulatory guidance and practical guidance. However, noting the target date for completion of its work (see para. 13 above), the Working Group noted that it might not be possible to complete all aspects of the guidance by 2008. The Working Group therefore requested the Secretariat to undertake consultations with experts and to draft the Guide to Enactment in the following order of priority: first, following completion of the relevant sections of the Model Law text, guidance for legislators in enacting its text; secondly, guidance for regulators, and, thirdly, perhaps, guidance for other users. At its final session before the revised Model Law text was presented to the Commission, the Working Group would consider the Model Law text and the guidance to legislators and regulators completed to date. The Secretariat would subsequently be entrusted with drafting any remaining aspects of the Guide for consideration by the Working Group.

¹ General Assembly resolution 58/4, annex.

B. The use of electronic communications in procurement (A/CN.9/WG.I/X/CRP.2 and A/CN.9/WG.I/WP.47)

1. Communications in procurement: new articles 5 bis and 9/5 ter

15. The Working Group considered the wording of the draft articles 5 bis and 9/5 ter as contained in document A/CN.9/WG.I/X/CRP.2, presented to the Working Group for its consideration in addition to the wording of the draft articles proposed in paragraph 3 of A/CN.9/WG.I/WP.47.

16. The general view was that the wording of draft article 5 bis in document A/CN.9/WG.I/X/CRP.2 was an improvement on the previous formulation, as it dealt with the issue of the use of communications in the procurement process in a way that was technologically neutral and addressed functional equivalence among various means of communications. It was suggested that some refinement to make the provisions as precise as possible could be considered, so as to avoid the risk that they could be interpreted differently in different jurisdictions. Furthermore, insufficient precision could inadvertently give rise to the risk of review actions. It was also suggested that the provisions should be drafted in such a way so as to ensure that they addressed all aspects of procurement under the Model Law, and not only communications generated during a particular procurement. An example of an aspect of procurement that could otherwise be excluded in some jurisdictions would be review procedures.

17. The Working Group considered whether the provisions in draft articles 5 bis and 9/5 ter should be consolidated in one article. The prevailing view was that they should be so consolidated because they both addressed the topic of communications in the procurement process.

18. The consideration of draft articles 5 bis and 9/5 ter then proceeded on the basis of a consolidated article, as follows:

“Article 5 bis. Communications during the procurement process

(1) Subject to the requirements set out in article [cross reference], the procuring entity shall select:

(a) The means by which documents, notifications, decisions and other information in the procurement proceedings are to be communicated by or to the procuring entity or any administrative authority involved in the procurement, or a supplier or contractor or to the public; and

(b) The means by which any requirement under this Law for information to be in writing or for a signature is to be satisfied.

(2) The means of communication of information selected, and of any requirements for writing and signatures being satisfied, must be readily capable of being used with those in common use among suppliers or contractors of the goods, services or construction being the subject matter of the procurement. Such means are to be specified by the procuring entity when first soliciting the participation of suppliers or contractors in the procurement proceedings.

(3) The provisions of paragraph 1 of this article shall apply equally to the creation of the record of the procurement proceedings, and holding meetings of suppliers or contractors.

(4) The procurement regulations shall establish measures to ensure the authenticity, integrity and confidentiality of documents, notifications, decisions and other communications or information.

(5) Subject to other provisions of this Law, documents, notifications, decisions and other information to be communicated by or to the procuring entity or any administrative authority involved in the procurement or a supplier or contractor shall be in a form that provides a record of information contained therein and shall be accessible so as to be usable for subsequent reference.

(6) Communication of information between suppliers or contractors and the procuring entity referred to in articles [7 (4) and (6), 12 (3), 31 (2)(a), 32 (1)(d), 34 (1), 36 (1), 37 (3), 44 (b) to (f) and 47 (1), to update for revisions to Model Law] may be made by means that do not provide a record of the information contained therein provided that, immediately thereafter, confirmation of the communication is given to the recipient of the communication in a form that provides a record of the information contained therein and is accessible so as to be usable for subsequent reference.”

19. The following drafting suggestions were made with respect to draft article 5 bis (1): (i) to use the word “specify” instead of “select” in the opening sentence and in subparagraph (2); (ii) to update the cross-references between means and form of communications following the consolidation of the draft article; (iii) as any requirement for information to be in writing or for a signature could be found in other laws, the procuring entity itself might not be in a position to stipulate how the requirements would be satisfied. Accordingly, the text could state either that the procuring entity should set out the requirements in the solicitation documents, referring where necessary to existing laws that governed the questions, or the words “unless regulated by other law” could be inserted in the beginning of subparagraph (b).

20. Regarding draft article 5 bis (2), it was suggested that the word “potential” be added to qualify “suppliers or contractors”, so as to make it clear that the provisions addressed suppliers at large. However, it was also recalled that article 2 of the Model Law defined “supplier or contractor” as including potential suppliers and contractors, according to the circumstances. The Working Group requested the Secretariat to consider whether the suggested addition would be necessary in this context, and also to consider whether the drafting of the proviso could be improved.

21. Regarding draft article 5 bis (3), it was agreed that the items referred to should be expanded to include other aspects of the procurement process that would be subject to the same requirements.

22. The Working Group considered the interrelationship between the provisions facilitating the use of electronic commerce already adopted (provisions that may be similar to the UNCITRAL Model Law on Electronic Commerce,² for example) and

² For the text of the Model Law, see *Official Records of the General Assembly, Fifty-first Session, Supplement No. 17 (A/51/17)*, annex I (also published in the *UNCITRAL Yearbook*, vol. XXVII:1996 (United Nations publication, Sales No. E.98.V.7), part three, annex I). The Model Law and its accompanying Guide to Enactment have been published as United Nations publication, Sales No. E.99.V.4, and are available in electronic form at the UNCITRAL website (www.uncitral.org/english/texts/electcom/ml-ecomm.htm).

the provisions adopted for the purposes of public procurement. It was noted that other branches of law, such as contract law and the law of electronic commerce, might regulate these issues in some jurisdictions, but that other issues arising in the procurement context might not be covered elsewhere. It was suggested that the paragraph be redrafted in the passive, providing that appropriate measures of authenticity, integrity and confidentiality should be provided for, but should be flexible so that to respect the particular circumstances in each enacting State. The Working Group's attention was drawn to the fact that this paragraph would provide for requirements applicable both to electronic and paper communications, introducing explicit requirements for the former.

23. The point was made that in drafting article 5 bis and any provisions for the Guide to Enactment on confidentiality, trade or other information that should be kept confidential (as required in article 45 of the Model Law, for example) should be distinguished from information that should be made public.

24. It was recalled that the reference to "accessibility" had been deleted from draft article 5 bis (4), as the focus of the paragraph should be on measures needed to ensure security of communication and information in procurement. Accessibility, it was said, aimed at another objective, namely non-discrimination, and should be dealt with elsewhere, or as a separate element of draft article 5 bis (4).

25. The question arose as to whether the Model Law would contain sufficient safeguards against discrimination in communication if article 9 (3) of the Model Law were replaced by the proposed article 5 bis (2). The positive phraseology of draft article 5 bis (2), it was said, was aimed at ensuring competition, rather than non-discrimination. However, the Working Group noted that the provisions of article 9 (3) could be inconsistent with giving the procuring entity the right to specify the means of communication in the procurement process. The Working Group recalled its consideration of this subject at its ninth session (A/CN.9/595, paras. 23-38), and in particular the reference to the preamble of the Model Law, which provided for the fair and equitable treatment of all suppliers and contractors. Recalling its wish for the Guide to Enactment to elaborate on the notion of non-discrimination, the Working Group decided to continue the approach of addressing the question in the Guide rather than reinserting article 9 (3).

26. It was also agreed that the title of the consolidated draft article, which would address both the means and form of communications in procurement, should be changed to "Communications in procurement" so as to convey the general scope of the article.

2. Electronic submission of tenders: revision to article 30 (5)

27. The Working Group considered the alternative proposals for article 30 (5) contained in paragraph 2 of document A/CN.9/WG.I/X/CRP.2, and in paragraph 21 of document A/CN.9/WG.I/WP.47. The Working Group was of the view that consideration of the revisions to article 30 (5) should proceed on the basis of the text in document A/CN.9/WG.I/X/CRP.2.

28. The following drafting suggestions were made to the proposed text of article 30 (5), which were accepted by the Working Group: (i) to merge the opening sentence in paragraph (a) with subparagraph (i); (ii) to split subparagraph (ii) into two parts, one dealing with submission of tenders in paper and the other with submission of tenders in any other form; (iii) to replace the word "protection" in subparagraph (ii) with the words "integrity and confidentiality", so as to ensure

consistency between articles 5 bis (4) and 30 (5)(d); (iv) to delete the word “security” in paragraph (d); and (v) to replace the words “the time of its submission” with either “the time of its receipt”, or with “the time as determined by the procuring entity but in no case later than the time of its receipt”. The latter formulation was preferred, such that the entire provision would read: “(d) the procuring entity shall preserve the integrity and confidentiality of a tender from the time as determined by the procuring entity, but in no case later than the time of its receipt, and shall ensure that the content of the tender is examined only after its opening in accordance with this Law”. The formulation was considered to provide sufficient flexibility in cases where responsibility for protection of tenders was assumed by the procuring entity earlier than the moment of receipt of tenders, so as to allow (for example) for the encryption and decryption of electronic tenders by a procuring entity rather than suppliers.

29. Doubts were expressed as regards the desirability of removing the concept of “security” from the proposed article 30 (5)(d). It was noted that the concept of “security” was different from (though related to) the concepts of integrity and confidentiality. The importance of preserving security in both the paper-based and electronic environments was stressed. The Working Group’s understanding was that sufficient safeguards were already provided in draft articles 30 (5) and 5 bis, as amended, to ensure adequate security in the procurement process as a whole and in the submission of tenders in particular.

30. The point was made that the Guide should provide assistance to enacting States as regards these issues. It was noted that separate treatment of submission and receipt of tenders in the paper and electronic environments might be justifiable, so as to avoid imposing more stringent requirements appropriate in the electronic environment on the paper-based environment, where they might not be necessary. It was also noted that imposing excessive requirements might discourage the use of electronic submission of tenders.

3. Electronic opening of tenders: revisions to new article 33 (4) (A/CN.9/WG.I/WP.47, paragraph 29)

31. The Working Group agreed to make the proposed text of new article 33 (4) technologically neutral by deleting references to “electronic”, “electronically”, and “optical” means of procurement and communication. It was also agreed that the words “capable of following [the opening of the tenders]” would be replaced with the words “fully apprised of” to convey the meaning that suppliers or contractors should be allowed not only to observe the opening process but also make comments instantaneously.

32. The Working Group decided that proposed paragraph 4 as amended would be merged with paragraph 2 of article 33, so that the latter would read as follows:

“(2) All suppliers or contractors that have submitted tenders, or their representatives, shall be permitted by the procuring entity to be present at the opening of tenders. Suppliers or contractors shall be deemed to have been permitted to be present at the opening of the tenders if they are fully apprised of the opening of the tenders contemporaneously through the means of communication used by the procuring entity.”

**4. Electronic publication of procurement-related information
(A/CN.9/WG.I/WP.47, paragraphs 30-37)**

Article 5

33. The Working Group agreed that article 5 would be split into two paragraphs as suggested in paragraph 31 of document A/CN.9/WG.I/WP.47. Significant important judicial decisions and administrative rulings would be required to be published, but with a requirement “to update [the information] on a regular basis if need be”, but there would be no requirement to “systematically maintain” that information.

Publication of information on forthcoming procurement opportunities

34. The Working Group noted developments at international and regional levels towards encouraging the publication of information on forthcoming procurement opportunities through regulation, in particular by providing incentives for such publication, such as allowing a shorter time period in the procurement process. Strong support was expressed for the inclusion of provisions on the publication of information on forthcoming procurement opportunities in the Model Law as, it was said, that practice encouraged procurement planning, led to better discipline in procurement (for example, reducing instances of splitting procurements to avoid the application of more stringent rules) and benefited suppliers and contractors (by allowing them to identify needs, plan the allocation of necessary resources and take other preparatory actions for the participation in forthcoming procurements).

35. Caution was expressed, however, as the benefits of such publication were not clearly established, and as the information could change (suppliers or contractors thereby incurring unnecessary costs having relied on it). The Model Law, it was said, should encourage best practice and should recognize that making available abundant irrelevant or misleading information (as opposed to useful and relevant information) might compromise the objectives of the Model Law, including transparency. On the other hand, it was noted that, in some jurisdictions, the publication of such information might already be required or necessary as part of the planning process.

36. The Working Group agreed that enabling provisions on publication of information on forthcoming procurement opportunities should be included in the Model Law, based on the wording in paragraph 33 of document A/CN.9/WG.I/WP.47. The text would be permissive, using the words “procuring entities may publish”. The Working Group considered that the word “may” required support to make the provision effective. In this regard, it was agreed that the Guide should refer to incentives that enacting States might provide for procuring entities to publish that type of information, and to any existing regulations and practices. The Working Group noted that the Guide should stress that suppliers or contractors would not be entitled to any remedy if the procurement were cancelled following its pre-advertisement. At the same time, the Guide should draw appropriate balance between the benefits and concerns that publication of that information might raise.

C. Draft provisions to enable the use of electronic reverse auctions in the Model Law (A/CN.9/WG.I/WP.48, A/CN.9/WG.I/WP.43, paragraphs 54-66, A/CN.9/WG.I/WP.43/Add.1, paragraphs 1-6, and A/CN.9/WG.I/WP.40, paragraph 27)

1. Location of the provisions on ERAs

37. The Working Group considered the structure of the Model Law as a whole, noting that the conditions for use and procedures to be applied in particular procurement methods appeared in different chapters of the Model Law. Noting that it might wish to consider altering that structure at a future time, the Working Group agreed on a preliminary basis to include provisions stipulating the conditions for the use of ERAs to chapter II of the Model Law (which listed methods of procurement and their conditions for use). Provisions on procedural matters of ERAs, it was agreed, would be included elsewhere, such as in chapter V of the Model Law (which described procedures for alternative methods of procurement). This location, it was observed, would also allow the use of ERAs in various procurement methods, such as tendering or request for quotations, or as a stand-alone method.

38. However, the Working Group noted that a final decision on the structure of the Model Law would be taken after new procurement techniques, such as ERAs and framework agreements, had been considered. It was also recognized that the current preference for tendering contained in article 18 of the Model Law might be revisited, so as to take account of evolving procurement techniques and tools.

39. The view was expressed that in any event the Model Law would have to impose requirements according to which a procuring entity would choose the procurement method most appropriate for given circumstances. It was also pointed out that the conditions for use of each procurement method would have to become more precise, especially in the light of the preliminary agreement in the Working Group that the selection of the method of procurement would no longer be exempted from the review under article 52 of the Model Law (A/CN.9/568, para. 112).

2. Conditions for the use of electronic reverse auctions: new article [36 bis] (A/CN.9/WG.I/WP.48, paragraphs 3-17)

Article [36 bis]

40. The Working Group considered the text of draft article 36 bis contained in paragraph 3 of document A/CN.9/WG.I/WP.48. It recalled that all provisions in article 36 bis had to be taken as a package in order to preserve safeguards against improper use of ERAs (A/CN.9/595, para. 96).

41. The following drafting suggestions were made, which were accepted by the Working Group: (i) to put references and provisions related to construction or services in square brackets throughout the text as an indication to enacting States that these types of procurement could be excluded from the scope of the article; and (ii) to delete the reference to “commonly used goods, construction or services” throughout the text and instead use consistently the reference to goods, construction or services that were generally available on the market.

42. The need for subparagraph (a) was questioned in the light of subparagraph (c) since the compliance with the conditions of the latter, it was said, led to the compliance with the requirements of subparagraph (a).

43. As regards subparagraph (d), views varied as to whether both options in the text should be retained, or whether only one should appear in the Model Law (with the Guide to Enactment referring to the other as a possible alternative). It was commented that neither approach would be desirable, if it resulted in conflicting provisions appearing in the Model Law and the Guide.

44. It was noted that the question raised which award criteria should be permitted in procurements through ERAs — price only, or price and other criteria. The view was expressed that to ensure the acceptability of the revised Model Law, its provisions should be drafted in a sufficiently flexible way allowing both price and non-price criteria in determining the successful bid. However, recalling that the primary understanding that ERAs were most suitable for procurements where the price was the only award criterion, it was also commented that the more permissive language of the second option might allow the introduction of non-price criteria in inappropriate circumstances.

45. After discussion, it was decided to retain both options in the Model Law, with the procurement regulations governing which option would be appropriate in the circumstances in any enacting State (to be reflected in the introduction to subparagraph (d)). The second option would be amended to read as follows: “Where the successful tender is to be determined on the basis of the price and other criteria that can be transformed into monetary units and can be evaluated automatically.”

46. It was the Working Group’s understanding that the Guide would explain in detail the options for enacting States as regards both alternatives under the prevailing circumstances on the ground, including the level of experience with ERAs in any given jurisdiction, whether any services or construction procurement could be handled through ERAs, and taking into account the sectors of the economy. In addition, the Guide should alert enacting States that ERAs might be prone to elevated risks of corrupt practices through outsourcing decision-making beyond government, such as to third-party software and service providers. The Working Group also noted that provision should be made to ensure that any criteria to be used in determining the successful bid and the evaluation process would be disclosed to suppliers and contractors in the solicitation documents. Further, it was stressed that care would be required to ensure that subjectivity in ERAs was not introduced (such as through a points system), and that simplicity and transparency in the process should be preserved.

Guide to Enactment text

47. The suggestion was made that, in addition to the points listed in paragraph 11 of document A/CN.9/WG.I/WP.48 as requiring a detailed commentary in the Guide, the Guide should stress that procuring entities should be aware of the opportunity costs arising from the use of ERAs (costs such as those flowing should vendors abandon the government market if required to bid through ERAs).

3. Procedures in the pre-auction phase: new article [47 bis] (A/CN.9/WG.I/WP.48, paragraphs 18-27)

48. The Working Group had before it the text of draft article 47 bis, contained in paragraph 18 of document A/CN.9/WG.I/WP.48. The Working Group proceeded with the consideration of the article on the understanding that it would subsequently be merged with article 47 ter (see paras. 57-63 below).

49. The understanding of the Working Group was that provisions on pre-auction procedures had to be revised to ensure consistency with article 36 bis. Some delegates in particular preferred that two different versions of an article dealing with pre-auction procedures be prepared as per the two alternative versions of paragraph (d) of article 36 bis previously agreed (see paras. 40-46 above).

50. The Working Group also agreed that the Model Law should not prevent appropriate use of ERAs as a procurement tool in procurement methods other than tendering, such as request for quotations, as well as in any other procurement techniques that may be envisaged by the revised Model Law, such as framework agreements and dynamic purchasing systems.

51. Independently of the issue of the assessment of the qualification of the suppliers and responsiveness of tenders, the Working Group noted that two types of ERAs should be envisaged: first, a simpler version with price or other modifiable elements that can be transformed to monetary units as the only award criteria; and, secondly, a more complex version, in which non-modifiable elements of the tender would be subject to a prior evaluation. The variable elements that could be expressed as monetary units would subsequently be submitted to the auction.

52. The following drafting suggestions were made, which were referred to the Secretariat for consideration in the preparation of a revised article: (i) with reference to paragraph (1), to set out, for those procurement methods that could appropriately include ERAs, which of the normal requirements for each such procurement method would apply to the ERAs to be conducted (for example, it was noted that article 34 (4)(c), setting out procedures for the evaluation and comparison of tenders, was not applicable to ERAs); (ii) to permit both the simpler and more complex ERAs set out above; (iii) to redraft the article in a way that would make it clear which pre-auction procedures were involved in the simpler and more complex ERAs; (iv) to reflect that the rules of the conduct of ERAs, the criteria for evaluation of tenders and any formula or other mechanism for automatic re-evaluation of tenders should be disclosed to suppliers or contractors in the beginning of the procurement process; (v) in paragraph (3), to replace the reference to article 34 (3) with a reference to article 34 (2) that dealt with the determination of tenders' responsiveness if references to tendering proceedings were to be retained; (vi) in the context of more complex ERAs, to state that invitations to participate in the auction (following pre-auction assessment(s)) were to be issued to the "bidders that had met mandatory criteria" or to the "bidders that had been chosen" rather than to all those whose tenders had been rejected as a result of those assessments; (vii) to reorder the sequence of the paragraphs to set out procedures common to both ERAs first; and (viii) to make the withdrawal of ERAs mandatory if in the opinion of the procuring entity the number of suppliers or contractors was insufficient to ensure effective competition at any time before the opening (rather than closure) of the auction (although it was noted that that approach was too prescriptive compared with a more flexible approach taken in some jurisdictions).

53. The Working Group considered proposed alternative wording of article 47 bis, which read as follows:

"Article [47 bis]. Conduct of electronic reverse auctions in the pre-auction period

(1) [The provisions of chapter III of this Law shall apply to procurement by means of electronic reverse auctions except to the extent that those provisions are derogated from in this article.]

- (2) The procuring entity may require either prequalification or, in addition, submission and assessment of initial tenders.
- (3) If the prequalification is required, the procuring entity shall prequalify suppliers or contractors in accordance with article 7 (5) and (6).
- (4) If the submission of initial tenders is required, the procuring entity shall carry out an initial assessment of the tenders to determine their responsiveness in accordance with article 34 (2).
- (5) The procuring entity shall send an invitation to participate in the auction to all suppliers or contractors except for those who have not been prequalified, or whose tenders have been rejected in accordance with article 34 (3).
- (6) The invitation to participate in the auction shall set out the manner and deadline by which suppliers and contractors shall register to participate in the auction. Unless already provided to suppliers or contractors, the invitation to participate in the auction shall include all information necessary to enable the supplier or contractor to participate in the auction.
- (7) The procuring entity shall ensure that the number of suppliers or contractors invited to participate in the auction is sufficient to secure effective competition. If the number of suppliers or contractors at any time before the opening of the auction, is in the opinion of the procuring entity insufficient to ensure effective competition, the procuring entity shall withdraw the electronic reverse auction.
- (8) If the successful tender shall be determined on the basis of not only price but price and criteria transformed into monetary units in accordance with article 36 bis [second (d)] [(e)], the procuring entity shall assess those elements of tenders that are not to be presented in the auction in accordance with such criteria and in accordance with the formula specified in the solicitation documents for the transformation of such elements into monetary units.”

54. In introducing the draft article, the point was made that the article applied only for the pre-auction phase; in the auction phase, elements other than price and the elements referred to in paragraph (8) of the draft article, if applicable, could be factored in to determine the winning tender. With reference to paragraph (8) of the draft article, it was also pointed out, that its scope had been narrowed in accordance with draft article 36 bis (d), second alternative.

55. The view was expressed that the drafting should allow for the inevitable evolution of ERAs so as to avoid the provisions becoming obsolete. Thus any ERA should be permitted, subject to a number of safeguards, including: (i) transparency through inter alia disclosure early in the procurement process, either in specifications or invitations to pre-qualify or invitation to participate in the auction, all information to suppliers that would allow them to determine how tenders would be evaluated and their ranking in the evaluation process vis-à-vis other participants; and (ii) objectivity through inter alia requiring the finality of the auction stage in determining the successful tender so as to prevent any post-auction evaluation.

56. The Secretariat was requested carefully to consider which of the items listed in paragraph 60 of document A/CN.9/WG.I/WP.43 might need to be retained in the revised provisions. The point was also made that in drafting the provisions either for the Model Law or the Guide no impression should be given that ERAs, even if all

criteria for their use under article 36 bis had been met, were necessarily the only or a desirable tool to be used. The Secretariat was requested to consult with experts having practical experience with the ERAs to ascertain that whatever was drafted for the Model Law and the Guide concerning ERAs was workable in practice. Certain parts of the Guide that might require specific review by experts, such as those on ERAs, could be presented separately.

4. Procedures in the auction phase: new article [47 ter] (A/CN.9/WG.I/WP.40, paragraph 27, and A/CN.9/WG.I/WP.43, paragraphs 54-58)

57. The Working Group had before it the text of draft article 47 ter, contained in paragraph 27 of document A/CN.9/WG.I/WP.40 as amended by the text in paragraph 55 of document A/CN.9/WG.I/WP.43. The Working Group proceeded with the consideration of the draft article recalling that it would subsequently be merged with article 47 bis (see para. 48 above).

58. It was noted that the article had been drafted to address ERAs in which the successful supplier would be chosen on the basis of price criteria alone. In the light of its decisions regarding article 36 bis (see paras. 40-46 above), the Working Group considered that the text should be expanded to address both the simple and more complex ERAs, and that other parameters decided during the Working Group's consideration of articles 36 bis and 47 bis (such as those designed to ensure objectivity and transparency in the use of ERAs) would apply equally, *mutatis mutandis*, to article 47 ter.

59. It was noted that, further to the Working Group's understanding that ERAs could be used as a procurement tool in different procurement methods and techniques, the provisions in the draft that referred only to procedures conducted in accordance with the provisions of chapter III (tendering proceedings) in paragraphs (3), (6) and (7) would be revised.

60. The question of the anonymity of the bidders during the ERA itself was discussed. The Working Group agreed that the preservation of this anonymity during the auction phase was critical. Views differed, however, as to whether that anonymity should be preserved after closure of the auction. The predominant view was that the identity of the successful supplier and the winning price should be disclosed, as they would be in any other procurement under the Model Law, *inter alia* so as to permit a review of the procurement if necessary, but that the Working Group would consider at a future session whether to include provisions regarding anonymity after closure of the auction.

61. The following comments were made on the text of the draft article: (i) in paragraph 1 (b), the words "lowest price submitted" should be replaced with the words "result of the auction according to the pre-disclosed formula"; (ii) in paragraph (2), the phrase "dates and times" should be replaced with "date and time"; (iii) in paragraph 3, the phrase "[may also at any time announce the number of participants in the auction but]" and the words "[during the auction]" should be deleted, and the Working Group would revisit at a future session the issue as to whether the references to articles 33 (2) and (3) should be replaced with the language that would reflect more clearly the use of ERAs; (iv) paragraph (3) bis should be placed in square brackets, pending the determination of the Working Group as to whether to retain the provision and, if so, what its contents should be so as to capture only those events that would justify the suspension or termination of an ERA; (v) in paragraph (5), the words "or ranked first according to the

pre-disclosed formula” should be inserted after the words “lowest price”; and (vi) in paragraph (6), the provision be revised to provide that if the successful supplier did not enter into a procurement contract, the procuring entity would not be in a position to select another bid and instead might hold another ERA or adopt another procurement method.

62. The Working Group decided to base its future deliberations on the following text:

“Article 47 ter. Conduct of electronic reverse auctions during the auction itself

(1) During an electronic reverse auction:

(a) There shall be automatic evaluation of all bids;

(b) Procuring entities must instantaneously communicate [the result] of the auction according to the pre-disclosed formula to all bidders on a continuous basis during the auction;

(c) All participating suppliers and contractors shall have an equal and continuous opportunity to revise their tenders in respect of those features presented through the auction process.

(2) The auction shall be closed in accordance with the precise method, date and time specified in the solicitation documents or in the invitation to participate in the auction.

(3) The procuring entity shall not disclose the identity of any bidder [until the auction has closed]. [Articles 33 (2) and (3) shall not apply to a procedure involving an electronic reverse auction].

[(3) bis The procuring entity may suspend or terminate the electronic reverse auction in the case of system or communications failures.]

(4) There shall be no communication between the procuring entity and suppliers or contractors during the electronic reverse auction other than as provided for in paragraphs 1 (b) and (c) above.

(5) The successful bid shall be the bid with the lowest price or ranked first according to the pre-disclosed formula at the time the auction closes.

(6) If the supplier or contractor submitting the successful bid in a procedure involving an electronic reverse auction is requested to demonstrate again its qualifications in accordance with [article 34 (6)] but fails to do so, if the supplier or contractor fails to sign a written procurement contract when required to do so, and/or fails to provide any required security for the performance of the contract, the procuring entity may not select another bid but may conduct another electronic reverse auction, which shall then be conducted in accordance with the provisions of this article, or adopt another method of procurement.

(7) Where appropriate, [any reference to a tender in the Model Law] the reference to a tender in articles [list relevant articles] shall be read to include a reference to an initial tender submitted in a procedure involving an electronic reverse auction.”

63. In the light of the different conditions for use and procedures that could arise in the use of the simpler and more complex ERAs, and the use of price and non-price criteria, the Working Group requested the Secretariat to consider the preparation of one composite draft for articles 47 bis and ter, to address all ERAs, or to separate the text into two alternatives, to reflect simpler and more complex ERAs. It was noted that if the Secretariat included the text in paragraph 57 of A/CN.9/WG.I/WP.43 addressing non-price criteria in the revisions to be considered at the next session, the word “current” should be deleted, and that the Working Group would consider at its next session whether the reference to “the result” of the ERA in paragraph (1) (b) of the draft article above should be to “the ranking” of the suppliers.

5. Other revisions to the text of the Model Law and the Guide to Enactment to enable the use of electronic reverse auctions (A/CN.9/WG.I/WP.43, paragraphs 59-66, and A/CN.9/WG.I/WP.43/Add.1, paragraphs 1-6)

General comment

64. It was the Working Group’s understanding that ERAs could be used in other procurement methods as well as tendering proceedings.

Record of procurement proceedings (article 11) (A/CN.9/WG.I/WP.43, paragraph 59) and modification and withdrawal of tenders (article 31) (A/CN.9/WG.I/WP.43, paragraphs 65-66)

65. The Working Group agreed to revisit the question of how to refer to the use of ERAs in the record, and how and when offers in the context of ERAs could be modified and withdrawn, at a future session.

Contents of solicitation documents (article 27) (A/CN.9/WG.I/WP.43, paragraphs 60-64)

66. The Working Group considered the provisions in paragraph 60 of document A/CN.9/WG.I/WP.43.

67. The following drafting suggestions were made: (i) to start the introduction to paragraph (n) bis with the phrase “in addition to the provisions in article 27”; (ii) in paragraph (n) bis (ii), to replace the reference to the “website address” with “address” or “website or other electronic address”; (iii) to replace the current (n) bis (iii) with “the rules for the conduct of the electronic reverse auction”; (iv) to expand paragraph (n) bis (iv) by referring in addition to the formula that would be used in the evaluation of criteria during the auction (noting that the suggested wording in paragraph 64 of document A/CN.9/WG.I/WP.43 would be amended to comply with articles 36 bis and 47 bis and ter and merged with paragraph (n) bis (iv)); (v) to reinstate, with the opening phrase stating “unless set out in the rules for the conduct of the electronic reverse auction”, the provisions of paragraph (n) bis (v), those provisions of paragraph (n) bis (vi) that referred to stages in ERAs and those provisions of paragraph (n) bis (vii) that referred to conditions under which bidders would bid (in particular the reference to increments); and (vi) to amend paragraph (n) bis (ix) to read as follows “all other information concerning the electronic reverse auction necessary to enable the supplier or contractor to participate in the auction”. The Working Group confirmed its understanding that the remaining issues of paragraph (n) bis would be addressed in the Guide.

68. The Working Group's understanding was that the Model Law should list only those requirements for the content of the solicitation documents in procurements conducted by way of ERAs that were crucial for the proper handling of ERAs and for the fair and equitable treatment of all suppliers and contractors. The rules of ERAs, which would be included in the solicitation documents, would list any additional requirements, including any technical requirements for a particular ERA. (Recommendations and guidance on those requirements should be discussed in the Guide).

Tender securities (article 32) (A/CN.9/WG.I/WP.43/Add.1, paragraphs 1 to 4)

69. The Working Group noted that tender securities were not often used in ERAs. Views differed as to whether the Guide should discourage requiring tender securities in the context of ERAs, or whether a more flexible approach would be desirable (in that requiring a tender security could serve as a disincentive to withdraw the bid before the opening of the auction).

*Examination, evaluation and comparison of tenders (article 34)
(A/CN.9/WG.I/WP.43/Add.1, paragraphs 5 to 6)*

70. The Working Group considered the provisions in paragraph 5 of document A/CN.9/WG.I/WP.43/Add.1.

71. The Working Group agreed that the following wording would be considered at a future session: "No change in a matter of substance in the initial tender, including changes in price, shall be sought, offered or permitted, except during the auction itself". That wording would make it sure, it was said, that changes to tenders in ERAs were permitted only during the auction phase itself, and would avoid giving the impression that during the auction phase changes could be made to make unresponsive tenders responsive.

D. Abnormally low tenders (A/CN.9/WG.I/WP.43/Add.1, paragraphs 7 to 13)

1. Proposed additions to article 34 of the Model Law

72. The Working Group considered the provisions in paragraph 8 of document A/CN.9/WG.I/WP.43/Add.1.

73. The following drafting suggestions were made: (i) to refer to "concerns as to the capacity of the tenderer(s) to perform the contract" throughout the text; and (ii) to amend paragraph 4 (a) bis (ii) to read as follows: "[t]he procuring entity has taken account of the information supplied, if any, but continues, on a reasonable basis, to hold those concerns".

74. The Working Group's understanding was that the supplier's refusal to provide information requested by the procuring entity should not give an automatic right to the procuring entity to reject the tender on the basis that it was abnormally low. The Working Group deferred its decision on whether any decision regarding abnormally low tenders by the procuring entity should be open to review. The Working Group noted that domestic regulation of that issue might vary significantly. It was suggested that the Working Group might revert to that point when it considered review provisions.

75. The Secretariat was requested to propose the appropriate location for the provisions, taking into account that the issue should not be limited to tendering proceedings, and that risks of ALTs should be examined and addressed by the procuring entity at any stage of the procurement, including through qualification of suppliers.

2. Proposed additions to the Guide to Enactment text addressing article 34

76. It was agreed that the Guide should discuss the issues raised in paragraph 8 of document A/CN.9/WG.I/WP.43/Add.1, other issues considered by the Working Group at its eighth session (A/CN.9/590, paras. 107-109) as well as issues discussed in a note by the Secretariat A/CN.9/WG.I/WP.36 (in particular danger of rejecting tenders applying “arithmetical methods”, and the cost-effectiveness and cost implications for SMEs of performance bonds and independent guarantees). The Working Group agreed that the Guide should highlight the importance of adequate examination of tenders for their responsiveness and supplier for their solvency, of precise and detailed specifications and of objective criteria, for identifying and rejecting ALTs.

77. As regards the text for the Guide in paragraph 13 of document A/CN.9/WG.I/WP.43/Add.1, the Secretariat was requested to: (i) consider the order in which the elements of guidance should be presented; (ii) reconsider the reference to “a normal level of profit” in paragraph (1) bis as that criterion might be subjective and possibly irrelevant in defining ALTs; and (iii) provide examples of ALTs rather than defining the concept.

78. With reference to paragraph (1) quater contained in paragraph 13 of document A/CN.9/WG.I/WP.43/Add.1, views varied on whether the Guide should contain more flexible wording regarding information that may be requested by procuring entities about the cost structure of tenders. The prevailing view was that procuring entities should be alerted that it might be inappropriate to request that type of information from suppliers, but that there would be no prohibition on doing so. The Secretariat was requested, in redrafting the provisions for the Guide, to take into account differences in regulation of the subject in various jurisdictions (for example, in some instances, contracting officials were barred from demanding information relating to cost structure, because of risks that such information could be misused).

E. Framework agreements (A/CN.9/WG.I/WP.44 and Add.1)

79. Some delegates and observers updated information in documents A/CN.9/WG.I/WP.44 and Add.1 in the light of the most recent developments in the use and regulation of framework agreement in their respective jurisdictions.

80. The Working Group noted that two major issues would primarily affect the preparation of any drafting materials on the subject: first, whether specifications could be altered within the operation of the framework agreements, and second, whether suppliers not parties to the original framework agreement could join it after the conclusion of the master contract. The view was expressed that the response to these questions would depend on the complexity and subject-matter of framework arrangements. It was suggested that the Model Law provisions should be drafted sufficiently broadly to accommodate any type of framework agreements.

81. The Working Group, recognizing the wide-spread use of framework agreements and noting positive experience with their use in some jurisdictions (and trends towards their express regulation), entrusted the Secretariat with the preparation of drafting materials for the Model Law and the Guide that would set out conditions for the use of framework agreements and provide necessary safeguards against commonly encountered problems in their use, such as risks of collusion among suppliers, corruption and anti-competitiveness.

V. Other business

82. The Working Group had before it a note by the Secretariat on legislative work of international organizations relating to public procurement (A/CN.9/598/Add.1) (see paras. 8 and 10 above). The Working Group took note of the recommendation by the Commission that the Working Group, in updating the Model Law and the Guide, should take into account the issue of conflicts of interest and should consider whether any specific provisions addressing that issue would be warranted in the Model Law (see para. 3 above).

83. In that context, the Working Group noted the provisions on conflicts of interest contained in the e-tendering and electronic reverse auctions requirements and guidelines of the multilateral development banks (the “MDBs”) for MDB financed procurement (A/CN.9/598/Add.1, paras. 15 and 17),³ and in article 9 of the United Nations Convention against Corruption (A/CN.9/598/Add.1, paras. 43-45). As regards the latter, the Working Group noted that article 9 (1)(e) of the Convention required taking, where appropriate, measures to regulate matters regarding personnel responsible for procurement, such as declaration of interest in particular public procurements, screening procedures and training requirements, which had no equivalent in the Model Law.

84. The Working Group also heard a report from the Secretariat on its participation at the coordination meeting of the MDBs (Rome, 19-20 September 2006) that discussed, inter alia a study being undertaken by the MDBs on the issues of corruption and technology in public procurement, in which conflicts of interest in the context of electronic procurement would be specifically addressed.

85. The Working Group agreed to add the issue of conflicts of interest to the list of topics to be considered in the revision of the Model Law and the Guide.

86. The Working Group also heard reports on current legislative and other related activities in the procurement field, from regional and international organizations and authorities and confirmed that its work in revising the Model Law should be undertaken in close cooperation with those organizations and authorities.

³ Section 12 of the E-Tendering Requirements and section 11 of the E-reverse Auction Guidelines, both available at www.mdb-egp.org.

**B. Note by the Secretariat on possible revisions to the UNCITRAL
Model Law on Procurement of Goods, Construction and
Services — drafting materials addressing the use of electronic
communications in public procurement and electronic
publication of procurement-related information, submitted
to the Working Group on Procurement at its tenth session
(A/CN.9/WG.I/WP.47) [Original: English]**

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I. Introduction

1. The background to the current work of Working Group I (Procurement) on the revision of the UNCITRAL Model Law on Procurement of Goods, Construction and Services (the “Model Law”) (A/49/17 and Corr.1, annex I) is set out in paragraphs 5 to 53 of document A/CN.9/WG.I/WP.46, which is before the Working Group at its tenth session. The main task of the Working Group is to update and revise the Model Law, so as to take account of recent developments, including the use of electronic communications and technologies, in public procurement.

2. Such use, including the electronic submission and opening of tenders, and holding meetings, storing information and the publication of procurement-related information electronically, was included in the topics before the Working Group at its sixth to ninth sessions.¹ At its ninth session, the Working Group requested the Secretariat to revise the relevant drafting materials that it had considered at the session.² This note has been prepared pursuant to that request, and sets out the drafting materials revised to take account of the Working Group’s deliberations at its ninth session.

II. Drafting materials addressing the use of electronic communications in public procurement

A. Means and form of communications

1. Proposed draft text for the revised Model Law

3. The Working Group has decided to continue its deliberations on the basis of the following two draft articles for the Model Law, drawing on the drafts before it at its ninth session³ and the provisions of article 9 of the current (1994) text of the Model Law:⁴

“Article 5 bis. Means of communication

(1) Any provision of this Law related to communicating [, to writing, to publication of information, to the submission of tenders in a sealed envelope, to the opening of tenders, to a record or to a meeting,] shall be interpreted to include electronic, optical or comparable means [by which such activities take place/of communication], provided that the means chosen are readily capable of being used with those in general [or common] use among suppliers or contractors.

(2) Documents, notifications, decisions and other communications between suppliers or contractors and the procuring entity shall be provided, submitted or effected by the means of communication specified by the procuring entity when first soliciting the participation of suppliers or contractors in the procurement proceedings, provided that the means specified are capable of being used as set out in the preceding paragraph.

¹ As regards electronic reverse auctions, see A/CN.9/WG.I/WP.48.

² A/CN.9/595, paras. 10-79.

³ A/CN.9/WG.I/WP.42, paras. 7, 17 and 20.

⁴ A/CN.9/595, paras. 40 and 44.

(3) The [procurement regulations or the procuring entity] [shall or may] establish measures to ensure the authenticity, integrity, accessibility and confidentiality of communications.

[(4) The provisions of paragraph 1 of this article shall apply equally to any provision of this Law related to writing, to publication of information, to the submission of tenders in a sealed envelope, to the opening of tenders, to a record or to a meeting.]”

“Article 9 [5 ter.] Form of communications

(1) Subject to other provisions of this Law, documents, notifications, decisions and other communications to be submitted by the procuring entity or administrative authority to a supplier or contractor or by a supplier or contractor to the procuring entity shall be in a form that provides a record of the content of the communication and is accessible so as to be usable for subsequent reference.

(2) Communications between suppliers or contractors and the procuring entity referred to in articles [7 (4) and (6), 12 (3), 31 (2)(a), 32 (1)(d), 34 (1), 36 (1), 37 (3), 44 (b) to (f) and 47 (1), to update for revisions to Model Law] may be made by a means of communication that does not provide a record of the content of the communication provided that, immediately thereafter, confirmation of the communication is given to the recipient of the communication in a form that provides a record of the content of the communication and is accessible so as to be usable for subsequent reference.”

Commentary — derivation, location and title

4. Proposed article 5 bis and the revised article 9 reflect the deliberations of the Working Group at its ninth session regarding the means and form of communications.⁵ Proposed article 5 bis contains text that does not appear in the current Model Law, and the revised article 9 draws on the provisions of the current article 9.

5. The Working Group at its ninth session noted that provisions in article 5 bis set out a fundamental principle relating to the use of communications in the procurement process (referring to the term “communications” in its broadest sense), and therefore should be placed early in the Model Law, before any identification of suppliers or contractors. Accordingly, it was agreed on a preliminary basis that they might follow the current article 5.⁶

6. The Working Group deferred its consideration of the title of proposed article 5 bis at its ninth session.⁷ The Working Group may consider that this article addresses the means of communication (whether paper-based or electronic), while the revised article 9 addresses the form of communications (in writing rather than oral and the content to be recorded). Accordingly, the Working Group may wish to reflect this difference in the titles of the articles.

⁵ A/CN.9/595, paras. 11 to 46.

⁶ A/CN.9/595, para. 37.

⁷ A/CN.9/595, para. 37.

7. The Working Group has not finally decided whether the above provisions should be contained in one or two articles, and whether they may usefully be located together (as articles 5 bis and 5 ter, for example). In this regard, the Working Group may wish to consider whether the differences between the “means” and “form” of communications are sufficiently clear and whether seeking to distinguish them may be helpful to the user of the Model Law. Alternatively, the Working Group may wish to provide for the “means” and “form” of communication in one composite article, which could be entitled “Communications” (see further para. 12 below).

Commentary — the text

8. The Working Group may wish to consider whether the reference to “means” (of communication) in the first paragraph of draft article 5 bis is sufficiently clear, or whether the word “means” should be qualified so as to make it clear that the reference is to “means of communication”. The Working Group may wish to consider the inclusion of a descriptive phrase such as the alternatives in square brackets: “by which such activities take place”, or “means of communication” to provide that reference, though noting that the second alternative would be intended to be interpreted broadly (explanation to such effect would be required in the Guide to Enactment).

9. Furthermore, the Working Group may wish to consider whether the first paragraph of article 5 bis fulfils the Working Group’s expressed wish to present the revised Model Law in a technologically neutral manner.⁸ The above draft refers only to “electronic, optical or comparable means” of communication, but not to paper-based means. An alternative formulation, expressed in technologically neutral manner, could read, for example, that:

“[a]ny provision of this Law related to communicating [...] shall be interpreted to include all means [by which such activities take place/of communication], including paper-based, electronic, optical or comparable means”.

10. The Working Group may wish to consider whether article 5 bis provides the functional equivalence desired, because there is no standard or requirement for communications generally, and the functional equivalent approach operates by providing that any requirements for paper can be satisfied by electronic communications.⁹ An alternative formulation might be for the provision to refer to such a requirement, which will be satisfied by paper-based or electronic means of communication. The Working Group may also wish to consider the addition of a statement that any communication issued in a procurement governed by the Model

⁸ While discussing a related issue, the Working Group noted “an inconsistency between the principle of “technological neutrality” in [this text] where a reference was made to a specific technology, which would have to be reconsidered in due course” (A/CN.9/595, para. 15). The Working Group’s attention is also drawn to the discussion at its ninth session regarding the submission of tenders, in which it was noted that a significant proportion of tenders are submitted in traditional format (A/CN.9/595, para. 55).

⁹ The Guide to Enactment accompanying the Model Law on Electronic Commerce notes in paragraph 16 that the “functional equivalent approach” “[...] is based on an analysis of the purposes and functions of the traditional *paper-based requirement* with a view to determining how those purposes or functions could be fulfilled through electronic-commerce techniques”. [emphasis added].

Law can be issued using any means of communication, be it paper-based, electronic, optical or comparable.¹⁰

11. The Working Group has noted that the first paragraph of draft article 5 bis also addresses not only communications, but also writing, publication of information, submission of tenders in a sealed envelope, opening of tenders, records and meetings. However, the second and third paragraphs address communications alone. The Working Group agreed at its ninth session to consider at a subsequent session whether these other references should be included in the first paragraph, alternatively in a separate fourth paragraph in the draft article, or elsewhere in the text. The bracketed text in paragraphs 1 and 4 of draft article 5 bis reflect that outstanding issue.¹¹

12. The Working Group may wish to consider that the first paragraph of article 5 bis should be a separate article, placed as article 2 bis and entitled “Interpretation”, as it deals with interpretation of subsequent provisions of the Model Law, including those related to publication of procurement-related information, the first of which appear already in article 5, i.e., before the proposed article 5 bis. The Working Group may also wish to consider that, if that approach is followed, paragraphs 2 and 3 of the proposed article 5 bis should be consolidated with the revised article 9 under the title “Communications”, or immediately following article 5 as article 5 bis.

13. The Working Group at its ninth session requested that the term “common” should be added to the term “general” as a qualifier to the means of communication in use among suppliers or contractors, so as to ensure that the means of communication should be sufficiently available.¹²

14. As regards the third paragraph of proposed article 5 bis, the Working Group has agreed to consider whether the procuring entity, rather than the enacting State by means of regulations, should address the issues of authenticity, integrity, accessibility and confidentiality of communications set out in that paragraph, and whether either the procuring entity or the enacting State should be given the option or should be required to do so. The bracketed text in the proposed text reflects that outstanding issue.¹³

15. As regards the revised article 9, the Working Group may recall that the text follows paragraphs 1 and 2 of the current text of article 9, with the addition of the phrase “and is accessible so as to be usable for subsequent reference” at the end of each paragraph. That phrase is included so as the requirement that communications should contain a record of their content endures over time, and so as to conform to articles 6 and 10 of the UNCITRAL Model Law on Electronic Commerce, which

¹⁰ The Working Group may also consider that a formulation of this type would enable the introduction of a functional equivalence provision governing electronic signatures in article 5 bis. See, further, paragraph 26 of this note.

¹¹ A/CN.9/595, para. 41.

¹² See draft text following paragraph 40 of A/CN.9/595. In this regard, the Working Group recalled that the term “generally” involves the notion of universality, and that the term “commonly” means that the technology is widely available, but perhaps not to all or nearly all users, as set out in A/CN.9/WG.I/WP.42, paragraph 18 (a).

¹³ A/CN.9/595, para. 43.

address the notion of “writing” and the retention of electronic communications, respectively.¹⁴

16. The Working Group has deferred its final consideration as to whether the current text of article 9 (3)¹⁵ should be retained in some form, so as to establish a general principle of non-discrimination in the use of communications, or whether the proposed article 5 bis, paragraph 1, provides sufficient safeguards. In this regard, the Working Group has observed that the notion of non-discrimination exists in addition to the current article 9 (3), in some other provisions of the current text of the Model Law, such as in positive terms of fair and equitable treatment of suppliers and contractors in the preamble paragraph (d). The Working Group has expressed the view that the current article 9 (3) could be superfluous in the light of the proposed new provisions of article 5 bis and the revised article 9 for communications generally, but that in the context of the possible mandatory submission of tenders electronically, a non-discrimination provision may still be required. The Working Group has also deferred its consideration of where in the text any general non-discrimination provision should be located.¹⁶

17. The Working Group at its ninth session confirmed that the selection of means and form of communications, be it paper-based or electronic means, or both, were decisions for the procuring entity. It was decided that the text of the Model Law should expressly allow more than one means or form of communications to be selected by the procuring entity.¹⁷ The text of draft article 5 bis and the revised article 9 above allow for more than one means to be selected.

¹⁴ For the text of the Model Law on Electronic Commerce, see *Official Records of the General Assembly, Fifty-first session, Supplement No. 17 (A/51/17)*, annex I (also published in the UNCITRAL Yearbook, vol. XXVII:1996 (United Nations publication, Sales No. E.98.V.7), part three, annex I). The Model Law and its accompanying Guide to Enactment have been published as United Nations publication, Sales No. E.99.V.4, and are available in electronic form at the UNCITRAL website: www.uncitral.org/uncitral/en/uncitral_texts/electronic_commerce/1996Model.html. The explanatory note to article 6 (see para. 50 of the Guide to Enactment of the UNCITRAL Model Law on Electronic Commerce) provides that “article 6 focuses upon the basic notion of the information being reproduced and read. That notion is expressed in article 6 in terms that were found to provide an objective criterion, namely that the information in a data message must be accessible so as to be usable for subsequent reference. The use of the word “accessible” is meant to imply that information in the form of computer data should be readable and interpretable, and that the software that might be necessary to render such information readable should be retained. The word “usable” is not intended to cover only human use but also computer processing. As to the notion of “subsequent reference”, it was preferred to such notions as “durability” or “non-alterability”, which would have established too harsh standards, and to such notions as “readability” or “intelligibility”, which might constitute too subjective criteria.”

¹⁵ The current text reads: “The procuring entity shall not discriminate against or among suppliers or contractors on the basis of the form in which they transmit or receive documents, notifications, decisions or other communications.” The Guide to Enactment text addressing this provision states that: “In view in particular of the as yet uneven availability and use of non-traditional means of communication such as EDI, paragraph (3) has been included as a safeguard against discrimination against or among suppliers and contractors on the basis of the form of communication that they use.”

¹⁶ A/CN.9/595, paras. 26 to 36 and 60.

¹⁷ A/CN.9/595, paras. 59 and 60.

2. Guide to Enactment text

18. The Working Group has requested that the Guide to Enactment text addressing the above provisions should:

(a) Contain an updated illustrative list of examples of “electronic, optical or comparable means” of communication;

(b) Explain that the provisions in draft article 5 bis (1), although deviating from the similar provisions in other UNCITRAL texts, are to the same effect as other UNCITRAL texts, including the United Nations Convention on Electronic Contracting;¹⁸

(c) State that the provisions of the proposed article 5 bis (1) are intended to be interpreted broadly so as to encompass any provisions in the Model Law implying physical presence or a paper-based environment;

(d) Contain some discussions on the role and place of electronic procurement in the context of electronic government;

(e) Set out situations in which the use of electronic means under the Model Law would be required and provide more guidance on the impact of varying levels of use of electronic commerce in enacting States;

(f) Expand on the notion of general availability of means of communication (from the perspective that procuring entities should take account of the level of penetration of electronic communications and technologies in the relevant market when making their selection of the means of communication for the procurement concerned as well as costs of such means);

(g) Highlight that recourse to which means of communication was objectively justifiable would vary from jurisdiction to jurisdiction and from procurement to procurement;

(h) Address technical issues such as interoperability and compatibility;

(i) Advise that stricter requirements might apply in certain circumstances (for example, under international treaties or imposed by multilateral development banks);

(j) Should stress that the use of mixed systems would be most appropriate during the transitional period after the introduction of electronic means of communications in procurement, and that the use of only electronic means would be promoted where appropriate in the longer term;

(k) Address the notion of discrimination and explain with examples how it might arise in practice;

(l) Clarify that the means of communication chosen should not pose an obstacle to the procurement process, as otherwise they will jeopardize the promotion of the Model Law’s objectives of maximizing economy and efficiency in procurement, as stated in its preamble paragraph (a); and

(m) Discuss in detail the issues raised by the authenticity, integrity, accessibility and confidentiality of communications.¹⁹

¹⁸ General Assembly resolution 60/21.

¹⁹ A/CN.9/595, paras. 11, 12, 14, 18 to 22, 30, 34, 38, 43 and 61.

19. The Working Group will be provided with draft Guide to Enactment text to reflect these points and its decisions on the issues set out in paragraphs 6 to 14 and 16 above for consideration at a future session.

B. Provisions related to legal value of procurement contracts concluded electronically and requirement to maintain a record of the procurement proceedings

20. The Working Group may recall that its drafting suggestions to the Guide to Enactment provisions before it (made at the ninth session)²⁰ related to legal value of procurement contracts concluded electronically and requirement to maintain a record of the procurement proceedings. The Working Group will be provided with draft Guide text to reflect those suggestions for consideration at a future session.

C. Drafting materials addressing the electronic submission of tenders, proposals and quotations

1. Proposed draft text for the revised Model Law

21. The Working Group decided to continue its deliberations regarding the electronic submission of tenders based on the following draft text for article 30 (5)(a):

“A tender shall be submitted [by the means specified in the solicitation documents, and shall be submitted] in writing, signed and in a sealed envelope”.²¹

Commentary

22. The Working Group noted at its ninth session that the proposed text addressed both the “means” and “form” of submission of tenders. Although the “means” of submission are in fact addressed in proposed article 5 bis (because tenders are “communications” within the ambit of that proposed article), the Working Group expressed the view that an express reference in article 30 (5)(a) to those means may be helpful, so as to make it clear that the words “in writing, signed and in a sealed envelope” address the “form” of tenders and not the “means” by which they are to be submitted.²²

23. As regards the “form” in which the tenders are to be submitted, the Working Group has noted that the form requirements that tenders should be submitted “in writing, signed and in a sealed envelope” are critical safeguards for the submission of tenders. Consequently, and despite the context of a paper-based environment that such a phrase implies, the Working Group decided that technologically neutral equivalents should not replace the terms “in writing, signed and in a sealed envelope”.²³

²⁰ A/CN.9/595, paras. 47-51.

²¹ A/CN.9/595, para. 63.

²² A/CN.9/595, para. 62.

²³ A/CN.9/595, para. 54.

24. In this regard, the Working Group also decided to remove an option contained in the current article 30 (5)(b) for the procuring entity to relax the form requirements. Article 30 (5)(b) in material part, which the Working Group has decided to delete, stated that tenders could be submitted “in any other form specified in the solicitation documents that provides a record of the content of the tender and at least a similar degree of authenticity, security and confidentiality”. (The reference to “other form” in this paragraph is to any form other than “in writing, signed and in a sealed envelope”.)

25. Although proposed article 5 bis makes it clear that the terms “in writing” and “in a sealed envelope” are intended to address both traditional, paper-based notions and their electronic counterparts, it does not address any requirements for signatures. Article 7 of the UNCITRAL Model Law on Electronic Commerce provides that requirements for signatures are satisfied by a reliable “method used to identify” a person and “to indicate that person’s approval” of the information contained in the electronic communication. Issues arising in the use of electronic and digital signatures are discussed in detail in the UNCITRAL Model Law on Electronic Signatures, whose text is derived directly from the UNCITRAL Model Law on Electronic Commerce.²⁴

26. The Working Group may recall that the use of electronic signatures varies widely from jurisdiction to jurisdiction, and in some cases electronic signatures are independently certified (in which case they are known as “digital signatures”).²⁵ However, commentators have noted that requiring the use of electronic and digital signatures may involve unnecessary technical burdens and operate as a disincentive to the take-up of electronic procurement. As the Working Group noted at its ninth session, some jurisdictions have sought to avoid the technical consequences of requiring an electronic document to be signed by referring to such documents simply as being capable of authentication.²⁶ The Working Group may wish to consider whether the Model Law should provide expressly for the functional equivalence of traditional signatures and their electronic counterparts, and if so the location of such a provision. The Working Group may recall that there is a signature requirement in the Model Law only as regards tenders and procurement contracts, and therefore a provision addressing signature could be located either in proposed article 5 bis, or in the articles governing the submission of tenders, and procurement contracts. Alternatively, the Working Group may consider that the functional equivalence of traditional and electronic signatures could be addressed in the Guide to Enactment.

²⁴ For the text of the Model Law on Electronic Signatures, see *Official Records of the General Assembly, Fifty-sixth Session, Supplement No. 17 (A/56/17)*, annex II. The Model Law and its accompanying Guide to Enactment have been published as United Nations publication, Sales No. E.02.V.8, and are available in electronic form at the UNCITRAL website (www.uncitral.org/uncitral/en/uncitral_texts/electronic_commerce/2001Model_signatures.html).

²⁵ Digital signatures involve encryption, sometimes using public key infrastructure, and require significant investment to set up. The private sector operates electronic commerce without digital signatures. For further detail, see the Final Report of the Conference on Electronic Government Procurement (E-GP) held by the multilateral development banks, Manila, 26-28 October 2004, available at www.mdb-egp.org/data/international.htm.

²⁶ A/CN.9/595, para. 56.

2. Guide to Enactment text

27. The Working Group has noted that the Guide to Enactment text should address the following issues regarding the electronic submission of tenders: (i) that the reference to “means” of submission of tenders implies the use of a purely electronic, purely paper-based or mixed system (in which suppliers may submit tenders in paper-based format or electronically, or in which suppliers may submit some parts of their tenders, such as samples, technical drawings or legal certificates, in paper-based format); (ii) the desirability of promoting electronic submission in the longer term, and the use of mixed systems as an interim measure; (iii) the equivalent safeguards to “in writing, signature and a sealed envelope”; (iv) the use of technologies such as virus-scanning software to mitigate the risk of tenders being deleted as a result of virus (so as to enhance confidence and transparency in the electronic environment); and (v) whether procuring entities should allow duplicate tenders in a different format as a safeguard against system failure and the safeguards that should also be applied to guard against abuse.²⁷

28. The Working Group will be provided with draft Guide to Enactment text to reflect these points and its decisions on the issue set out in paragraph 26 above, for consideration at a future session.

D. Electronic opening of tenders

29. The Working Group preliminarily agreed on the wording of the proposed text for article 33 (4) of the Model Law, which reads:

“Article 33. Opening of tenders

(4) Where the procurement proceedings were conducted electronically in accordance with [insert provisions dealing with electronic communications, reverse auctions and other fully automated procedures], suppliers or contractors shall be deemed to have been permitted to be present at the opening of the tenders in accordance with the requirements of article 33 (2) if they are capable of following the opening of the tenders contemporaneously through the electronic, optical or comparable means of communication used by the procuring entity.”²⁸

E. Electronic publication of procurement-related information

1. Proposed draft text for the revised Model Law

30. At its ninth session, the Working Group preliminarily agreed to retain the current text of article 5 of the Model Law without change and reflect the proposed additional points²⁹ in the Guide.³⁰

31. The Working Group is to decide at its tenth session whether the Secretariat, in preparing the revised article 5, should split the article into two paragraphs as was suggested at the Working Group’s ninth session: the first paragraph dealing with

²⁷ A/CN.9/595, paras. 57-59.

²⁸ A/CN.9/595, paras. 64 and 65, and A/CN.9/WG.I/WP.42, paras. 35-37.

²⁹ A/CN.9/WG.I/WP.42, para. 38.

³⁰ A/CN.9/595, paras. 66-74.

legal texts that had to be published (law, procurement regulations and directives of general application), with respect to which the requirements to “systematically maintain” would remain; and the second paragraph dealing with significant important judicial decisions and administrative rulings, with respect to which the requirement to “systematically maintain” would be replaced with the requirement “to update on a regular basis if need be”. That suggestion was met with some support in the Working Group; however, no definitive decision was taken.³¹

32. The Working Group is expected to continue considering at its tenth session desirability of including in the Model Law provisions on the publication of information on forthcoming procurement opportunities, either as a part of article 5 or a separate article, in the light of deliberations at its ninth session.³² The suggestion was made at that session that in the consideration of this issue, the Working Group should assess whether the practice of publication of this type of information would be consistent with objectives of the Model Law, and if so whether there would be the need for a specific enabling provision in the Model Law to promote the practice.³³

33. Also at that session, some changes were suggested to the proposed wording on the publication of information on forthcoming procurement opportunities, and the text as amended in the light of those changes reads as follows:

“As promptly as possible after beginning of a fiscal year procuring entities [shall/may] publish information of the expected procurement opportunities for the following [the enacting State specifies the period], and this information shall not constitute the solicitation documents or parts thereof.”³⁴

34. The Working Group is to consider whether the text, if it is included in the Model Law, should be enabling or prescriptive (“shall publish” or “may publish”).³⁵ The Working Group may wish to consider whether an alternative formulation, such as noting that the procurement regulations may address the publication of additional procurement-related information, with the Guide to Enactment providing appropriate guidance as to the extent of publication to be required, might provide additional flexibility in the matter.

2. Guide to Enactment text

35. The Working Group has requested that the Guide to Enactment should address desirability of making available to public and of updating as need be the following information:

(a) Judicial decisions with precedent value and of general application on the application of procurement law;³⁶

(b) Additional information regarding internal controls, guidance or other information;

³¹ A/CN.9/595, para. 71.

³² A/CN.9/595, paras. 75-78.

³³ A/CN.9/595, para. 78.

³⁴ A/CN.9/595, para. 76.

³⁵ A/CN.9/595, paras. 76 and 77.

³⁶ A/CN.9/595, paras. 68 and 74.

(c) All other documents and information that the Model Law requires to be published with specific references thereto;³⁷ and

(d) Information on forthcoming procurement opportunities.³⁸

36. The Guide will also address practical difficulties of making legal texts available and accessible, media and manner of publication, and the notion of “systematic maintenance” referred to in the current article 5.³⁹

37. The Working Group has also requested making minor amendments to the proposed text for the Guide to Enactment before it at its ninth session.⁴⁰ The Working Group will be provided with the revised draft Guide to Enactment text, reflecting those suggestions and suggestions in paragraphs 35 and 36 above as well as the Working Group’s decisions on the outstanding issues set out in paragraphs 31, 32 and 34 above, for consideration at a future session.

³⁷ A/CN.9/595, para. 74.

³⁸ A/CN.9/595, paras. 76-78.

³⁹ A/CN.9/595, paras. 69, 70 and 72.

⁴⁰ A/CN.9/595, para. 79.

**C. Note by the Secretariat on possible revisions to the UNCITRAL Model Law
on Procurement of Goods, Construction and Services — drafting materials
addressing the use of electronic reverse auctions in public procurement,
submitted to the Working Group on Procurement at its tenth session
(A/CN.9/WG.I/WP.48) [Original: English]**

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I. Introduction

1. The background to the current work of Working Group I (Procurement) on the revision of the UNCITRAL Model Law on Procurement of Goods, Construction and Services (the “Model Law”) (A/49/17 and Corr.1, annex I) is set out in paragraphs 5 to 53 of document A/CN.9/WG.I/WP.46, which is before the Working Group at its tenth session. The main task of the Working Group is to update and revise the Model Law, so as to take account of recent developments, including the use of electronic communications and technologies, in public procurement.

2. Such use, including the use of electronic reverse auctions (ERAs), was included in the topics before the Working Group at its sixth to ninth sessions.¹ At its ninth session, the Working Group requested the Secretariat to revise the

¹ See A/CN.9/WG.I/WP.35, A/CN.9/WG.I/WP.40, A/CN.9/WG.I/WP.43 and their addenda. For other related topics, see A/CN.9/WG.I/WP.47.

drafting materials that it had considered at the session on this topic.² This note has been prepared pursuant to that request, and sets out the drafting materials revised to take account of the Working Group's deliberations at its ninth session.

II. Drafting materials addressing the use of electronic reverse auctions in public procurement

A. Conditions for use of electronic reverse auctions

1. Proposed draft text for the revised Model Law

3. The Working Group has decided to continue its deliberations on the basis of the following draft article for the Model Law:³

“Article [36 bis]. Conditions for use of electronic reverse auctions

“A procuring entity may engage in procurement by means of an electronic reverse auction in accordance with article[s ...] in the following circumstances:

(a) Where it is feasible to formulate detailed and precise specifications for the goods, construction or services;

(b) Where there is a competitive market of suppliers or contractors that are anticipated to be qualified to participate in the electronic reverse auction such that effective competition is ensured;

(c) Where the procurement concerns:

(i) Commonly used goods[, which are generally available on the market]; or

(ii) Commonly used construction or services, [which are generally available on the market and] provided that the construction or services are of a simple nature; and

[(d) Where the price is the only criterion to be used in determining the successful tender;

or

(d) Where the price and [only/any] other criteria that can be expressed in figures or transformed into monetary units and can be [evaluated automatically/evaluated in automatic processes] are to be used in determining the successful tender.]”

Commentary — aims and location of the provisions

4. The aim of the above provisions is to establish the essential legal framework for operation of ERAs, to reflect both general procurement principles and those specific to the operation of such auctions. However, the Working Group has also noted that the relative novelty of ERAs requires that the text be as broad as possible

² A/CN.9/595, paras. 87-111.

³ A/CN.9/595, para. 95. Minor changes have also been made to the draft before the Working Group at its ninth session so as to conform the text with the Model Law's style.

to allow for evolution of the practice.⁴ There was agreement in the Working Group that all provisions in the proposed article 36 bis should be taken as a package, so as to preserve the effect of all safeguards contained therein.⁵

5. As regards location, the Working Group has provisionally decided to include the article as a new section IV entitled “Electronic reverse auctions” within chapter III of the Model Law (Tendering proceedings), while not excluding the possibility of using ERAs as a stand-alone procurement method or as a phase in multi-stage framework agreements.⁶ As chapter III addresses the procedures to be followed in tendering proceedings, but not the conditions for use of particular types of tendering (such as two-stage tendering), the Working Group may wish to consider whether an alternative location for provisions regulating ERAs would be more consistent with the structure of the current Model Law. In the case of two-stage tendering, for example, the conditions for use are set out in article 19 of the Model Law (which falls within chapter II), and the procedures to be followed in article 46 (which falls within chapter V). The Working Group may also wish to recall that the first paragraph of article 46 states that “[t]he provisions of chapter III of this Law shall apply to two-stage tendering proceedings except to the extent those provisions are derogated from in this article.” If this formulation were followed for ERAs, the above article would be included within chapter II, and the procedural provisions discussed in sections II.C and II.D of A/CN.9/WG.I/WP.43 within chapter V.

6. The Working Group may also wish to consider that this approach could ease the use of ERA procedures for a stand-alone procurement method (akin to the request for quotations procedure, with which it could also be combined in circumstances where a fully open procedure is not required) or for a phase in multi-stage framework agreements.

7. On the other hand, and in the light of the striving for consistency in the Model Law, the Working Group may alternatively decide to incorporate those parts of chapters II and V that address forms of tendering proceedings within chapter III, including ERAs.

Commentary — the text

8. As regards paragraph (a) of the proposed text, the Working Group has noted that its provisions may be redundant in the light of article 27 (d) of the Model Law,⁷ and has agreed further to consider whether the paragraph should be included. In this regard, the Working Group may consider that the requirement for “detailed and precise specifications” is one of the overriding criteria that determine whether an ERA is a suitable method of procurement in any given case, and therefore the paragraph should be included in this article even if not strictly necessary.

⁴ A/CN.9/595, para. 89.

⁵ A/CN.9/595, para. 96.

⁶ A/CN.9/595, paras. 95 and 103.

⁷ See, further, A/CN.9/595, para. 99. Article 27(d) requires the solicitation documents to contain at least the following information regarding specifications: “The nature and required technical and quality characteristics, in conformity with article 16, of the goods, construction or services to be procured, including, but not limited to, technical specifications, plans, drawings and designs as appropriate; the quantity of the goods; any incidental services to be performed; the location where the construction is to be effected or the services are to be provided; and the desired or required time, if any, when the goods are to be delivered, the construction is to be effected or the services are to be provided.”

9. As regards the second option for paragraph (d), the Working Group has agreed to reconsider whether the auction of non-price criteria should be recognized in the text of the Model Law, or whether reference to non-price criteria should be made in the Guide to Enactment alone.⁸ In this regard, the Working Group may wish to consider whether the Guide can introduce variations to the text of the Model Law, rather than provide detailed guidance as to the application of the Model Law's provisions.

10. The precise drafting of the following items in the text remains outstanding:⁹

(a) In paragraph (c), whether to retain the reference to "generally available on the market";

(b) In the second option for paragraph (d), whether to insert the word "only" or "any" before the phrase "other criteria"; and

(c) Also in the second option for paragraph (d), whether to amend the phrase "evaluated automatically", such as by replacing it with the phrase "evaluated in automatic processes".

2. Guide to Enactment text

11. The Working Group has noted that the following criteria are critical for the successful use of ERAs, and should receive detailed commentary in the Guide to Enactment text:

(a) That clear specifications must be established and made known to suppliers at the outset of procurement;¹⁰

(b) That ERAs are suitable for commonly used goods and services;¹¹

(c) The importance of a sufficient number of participating suppliers to ensure competition;¹²

(d) Preservation of the anonymity of bidders (also in the broader context of competition and fair dealing);¹³

(e) That consolidated purchases are to be encouraged to amortize costs;¹⁴

(f) The critical need to allow price and, if at all, only limited non-price criteria that fulfil the conditions of the second option for paragraph (d) of the proposed article 36 bis (such as delivery times and technical considerations) to be auctioned, so as to avoid the introduction of subjective elements when quantifying such criteria, and to guard against the possibility of abuse;¹⁵

(g) That ERAs are to be a single and final round before a winner is selected, also so as to guard against abuse;¹⁶

⁸ A/CN.9/595, para. 99.

⁹ A/CN.9/595, para. 98.

¹⁰ A/CN.9/595, para. 89.

¹¹ A/CN.9/595, paras. 102 and 103.

¹² A/CN.9/595, para. 101.

¹³ A/CN.9/595, paras. 89 and 101.

¹⁴ A/CN.9/595, para. 90.

¹⁵ A/CN.9/595, para. 101.

¹⁶ A/CN.9/595, para. 101.

(h) That the winning price is to figure in the contract, including in the case of framework agreements;¹⁷ and

(i) That the timing of the opening and criteria governing the closing of ERAs are to be clearly specified in advance.¹⁸

12. In addition, the Working Group has expressed the view that the Guide should explain that construction or services would not normally fulfil the conditions for use of ERAs, unless they were of a highly simple nature.¹⁹ It was also understood in the Working Group that paragraph 35 of A/CN.9/WG.I/WP.43, in particular its provisions on commodities (fuel, standard information technology equipment, office supplies and primary building products), and items with no or limited impact from post-acquisition costs and without services or added benefits after the initial contract is completed, should remain as the text for the Guide accompanying the proposed article 36 bis.

13. Although the proposed article envisages criteria other than price to be subject to the auction in the second option for paragraph (d), the understanding in the Working Group was that the Guide should alert to potential dangers of using such other criteria.²⁰ In this regard, the Working Group may consider that the Guide should encourage enacting States that have not yet used the technique to introduce ERAs in a staged fashion: that is, to allow price only to be auctioned initially, and subsequently to allow non-price criteria to be introduced as experience in the technique is gained and practices evolve.

14. The Guide will also clarify that the term “qualified” used in subparagraph (b) does not mean that pre-qualification will necessarily be a feature of ERAs.²¹

15. In addition, the Working Group has suggested that the Guide should note that the use of a common procurement vocabulary to identify goods, construction or services by codes or by reference to general market-defined standards would be of assistance. Developing lists with goods, construction or services that were not suitable for ERAs or a list that would describe characteristics of goods, construction or services, which if present would make such goods, construction or services suitable for ERAs could also be discussed in the Guide (as opposed to developing a positive list that would be difficult to update).²²

16. The Working Group has also noted that establishing the lowest price below which bids would not be accepted could be an important safeguard for proper management of ERAs and to guard against abnormally low tenders.²³

17. The Working Group will be provided with draft Guide text to reflect these points and the decisions on outstanding issues for its consideration at a future session.

¹⁷ A/CN.9/595, para. 101.

¹⁸ A/CN.9/595, para. 101.

¹⁹ A/CN.9/595, para. 100.

²⁰ A/CN.9/595, para. 100.

²¹ A/CN.9/595, para. 100.

²² A/CN.9/595, para. 102.

²³ A/CN.9/595, para. 91.

B. Procedures in the pre-auction period

18. The Working Group has requested the Secretariat to redraft proposed article 47 bis²⁴ to confer sufficient flexibility as regards distinct types of ERAs and the withdrawal of suppliers from the ERA before its closure, provided that sufficient safeguards were in place against fraud and abuse.²⁵ The revised draft for the consideration by the Working Group follows:

“Article [47 bis]. Conduct of electronic reverse auctions in the pre-auction period

(1) [The provisions of chapter III of this Law shall apply to procurement by means of electronic reverse auctions except to the extent that those provisions are derogated from in this article.]

(2) The invitation to tender shall set out whether suppliers or contractors are required to submit initial tenders that are complete in all respects prior to the auction.

(3) If the submission of initial tenders is required, the procuring entity shall carry out an initial examination of the tenders to determine their responsiveness in accordance with article 34 (3), [the qualification of suppliers or contractors,] [and to assess all elements of tenders that are not to be presented in the auction in accordance with the award criteria set].

(4) The procuring entity shall send an invitation to participate in the auction to all suppliers or contractors except for those whose tenders have been rejected under paragraph (3).

(5) The invitation to participate in the auction shall set out the manner and deadline by which suppliers and contractors shall register to participate in the auction.

(6) The procuring entity shall ensure that the number of suppliers or contractors invited to participate in the auction is sufficient to secure effective competition. If the number of suppliers or contractors at any time before the closure of the auction, is in the opinion of the procuring entity insufficient to ensure effective competition, the procuring entity [may/shall] withdraw the electronic reverse auction.

(7) Unless already provided to suppliers or contractors, the invitation to participate in the auction shall include all information necessary to enable the supplier or contractor to participate in the auction.”

Commentary

19. The Working Group has noted that there are two ways in which provision may be made for ERAs — in the first, an ordinary tendering proceeding would be conducted, including an assessment of the responsiveness of the initial tender and the qualifications of the suppliers, with all the safeguards of the sealed envelope system. Thereafter, all qualified suppliers who submitted responsive tenders would be invited to participate in the ERA that would determine the winner. In the second,

²⁴ See A/CN.9/WG.I/WP.43, text following para. 39.

²⁵ A/CN.9/595, para. 108.

there would be no initial assessment, and no control of the responsiveness of the tender or qualifications of the supplier until after the auction had closed.²⁶

20. The Working Group has requested that the text be drafted in a manner that is sufficiently wide for either type of ERAs to be conducted provided that sufficient safeguards are in place to protect against fraud and abuse.²⁷ The above draft follows that request. The paragraphs of the draft text have been renumbered to allow for one procedure for either system, with an additional step in new paragraph 3 if initial tenders are required.

21. Paragraph 1 of the draft text will not be required if the text is located together with draft article 36 bis above within chapter III of the Model Law, as was suggested at the Working Group's ninth session.²⁸

22. Paragraph 2 of the draft text makes it clear that either of the systems for conducting ERAs can be used, with the safeguard that the system is specified at the outset. The provisions of article 27 (a) of the current text of the Model Law, which require the solicitation documents to provide instructions for preparing tenders, will then require the procuring entity to set out appropriate detail to reflect the relevant circumstances. Appropriate guidance on this aspect would be set out in the Guide to Enactment text.

23. The words "the qualification of suppliers or contractors" can be included in paragraph 3 of the draft text if the Working Group considers that attention should be drawn to the fact that the qualifications of suppliers should be examined before the invitations to participate are issued if the second system is used, so as to ensure sufficient number of qualified participants.

24. In the light of the proposed article 36 bis (d) that does not envisage ERAs where not all elements of tenders are presented to and assessed in the auction, the Working Group may wish to consider whether the wording "[and may assess all elements of tenders that are not to be presented in the auction in accordance with the award criteria set]" should be retained so as to allow the ranking of tenders in more complex electronic reverse auctions using non-price criteria. Alternatively, any appropriate guidance in the Guide to Enactment on why this type of ERAs should not be envisaged may be formulated.

25. The Working Group has expressed concerns that allowing suppliers to withdraw from the ERA may endanger the effectiveness of the auction (and also may mean that the use of the technique ceases to be cost-effective). The withdrawal of suppliers may jeopardize effective competition, and the revisions to former paragraph 3 (d) of the proposed article 47 bis (now paragraph 6 above) reflect the Working Group's reflections at its ninth session on the question. The Working Group has deferred to a future session its consideration of whether a procuring entity should be obliged or enabled to withdraw the auction if competition is insufficient, and as to when and how suppliers might withdraw from the auction process before its closure, guidance on which point will be provided in the text of the Guide to Enactment.²⁹

²⁶ A/CN.9/595, paras. 106 and 107.

²⁷ A/CN.9/595, para. 108.

²⁸ A/CN.9/595, para. 95.

²⁹ A/CN.9/595, para. 111.

26. Paragraph 7 of the text would be supplemented by commentary in the Guide as to the information required (such as that described in subparagraphs 4 (e)(ii)-(v) and (vii)-(xii) following paragraph 20 of A/CN.9/WG.I/WP.40).

27. The Working Group has also requested that the Guide should explain that the provisions in the Model Law were intended to confer sufficient flexibility to allow ERAs to be conducted in either of the ways described above, depending on the circumstances prevailing in the country concerned, and should address the safeguards that should be in place to allow either systems to operate consistently with the objectives and main procedures of the Model Law, including any differences between procedures at ERAs and those main procedures.³⁰ The Working Group will be provided with draft text to reflect these points and the decisions on outstanding issues for its consideration at a future session.

C. Procedures in the auction phase, and further revisions to the text of the Model Law and Guide to Enactment required to enable the conduct of electronic reverse auctions

28. The Working Group has deferred to a future session its consideration of the matters discussed in sections II.D-G of A/CN.9/WG.I/WP.43 and in A/CN.9/WG.I/WP.43/Add.1.

³⁰ A/CN.9/595, para. 109.

D. Report of the Working Group on Procurement on the work of its eleventh session (New York, 21-25 May 2007)

(A/CN.9/623) [Original: English]

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I. Introduction

1. At its thirty-seventh session, in 2004, the United Nations Commission on International Trade Law (the “Commission”) entrusted the drafting of proposals for the revision of the 1994 UNCITRAL Model Law on Procurement of Goods, Construction and Services (the “Model Law”, A/49/17 and Corr.1, annex I) to its Working Group I (Procurement). The Working Group was given a flexible mandate to identify the issues to be addressed in its considerations, including providing for new practices in public procurement, in particular those that resulted from the use of electronic communications (A/59/17, para. 82). The Working Group began its work on the elaboration of proposals for the revision of the Model Law at its sixth session (Vienna, 30 August-3 September 2004) (A/CN.9/568). At that session, it decided to proceed at its future sessions with the in-depth consideration of topics in documents A/CN.9/WG.I/WP.31 and 32 in sequence (A/CN.9/568, para. 10).

2. At its seventh to tenth sessions (New York, 4-8 April 2005, Vienna, 7-11 November 2005, New York, 24-28 April 2006, and Vienna, 25-29 September 2006, respectively) (A/CN.9/575, A/CN.9/590, A/CN.9/595 and A/CN.9/615), the Working Group considered the topics related to the use of electronic communications and technologies in the procurement process: (a) the use of electronic means of communication in the procurement process, including exchange of communications by electronic means, the electronic submission of tenders, opening of tenders, holding meetings and storing information, as well as controls over their use; (b) aspects of the publication of procurement-related information, including possibly expanding the current scope of article 5 and referring to the publication of forthcoming procurement opportunities; and (c) electronic reverse auctions (ERAs), including whether they should be treated as an optional phase in other procurement methods or a stand-alone method, criteria for their use, types of procurement to be covered, and their procedural aspects. At its tenth session, the Working Group came to preliminary agreement on the draft revisions to the Model Law and the Guide to Enactment to the Model Law (the “Guide”) that would be necessary to accommodate the use of electronic communications and technologies (including ERAs) in the Model Law. At that session, the Working Group decided that at its eleventh session it would proceed with further consideration of those draft revisions (A/CN.9/615, para. 11).

3. At its seventh, eighth and tenth sessions, the Working Group in addition considered the issues of abnormally low tenders (ALTs), including their early identification in the procurement process and the prevention of negative consequences of such tenders. At its tenth session, the Working Group requested the Secretariat to propose the appropriate location for the provisions on ALTs, taking into account that the issue should not be limited to tendering proceedings, and that risks of ALTs should be examined and addressed by the procuring entity at any stage of the procurement, including through qualification of suppliers (A/CN.9/615, para. 75).

4. At its tenth session, the Working Group also took up the topic of framework agreements and requested the Secretariat to prepare drafting materials for the Model Law on the use of framework agreements (A/CN.9/615, para. 11). At the same session, the Working Group considered the recommendation by the Commission at its thirty-ninth session that the Working Group, in updating the Model Law and the Guide, should take into account issues of conflict of interest and should consider whether any specific provisions addressing those issues would be warranted in the

Model Law (A/61/17, para. 192). The Working Group agreed to add the issue of conflicts of interest to the list of topics to be considered in the revision of the Model Law and the Guide (A/CN.9/615, para. 11).

5. At its thirty-eighth and thirty-ninth sessions, in 2005 and 2006, respectively, the Commission commended the Working Group for the progress made in its work and reaffirmed its support for the review being undertaken and for the inclusion of novel procurement practices in the Model Law (A/60/17, para. 172, and A/61/17, para. 191).

II. Organization of the session

6. The Working Group, which was composed of all States members of the Commission, held its eleventh session in New York, from 21 to 25 May 2007. The session was attended by representatives of the following States members of the Working Group: Canada, Chile, China, Colombia, Czech Republic, France, Germany, Guatemala, Iran (Islamic Republic of), Kenya, Lithuania, Mexico, Nigeria, Pakistan, Poland, Republic of Korea, Russian Federation, Singapore, Spain, Sweden, Thailand, Turkey, United States of America, Venezuela (Bolivarian Republic of) and Zimbabwe.

7. The session was attended by observers from the following States: the Democratic Republic of the Congo, Holy See, Honduras, Indonesia and Lao People's Democratic Republic.

8. The session was also attended by observers from the following international organizations:

(a) *United Nations system*: United Nations Office of Legal Affairs and the World Bank;

(b) *Intergovernmental organizations*: Asian-African Legal Consultative Organization (AALCO), European Commission, European Space Agency (ESA), International Development Law Organization (IDLO) and the World Trade Organization (WTO);

(c) *International non-governmental organizations invited by the Working Group*: International Bar Association (IBA), International Law Institute (ILI) and the European Law Students' Association (ELSA).

9. The Working Group elected the following officers:

Chairman: Mr. Tore WIWEN-NILSSON (Sweden)

Rapporteur: Sra. Ligia GONZÁLEZ LOZANO (Mexico)

10. The Working Group had before it the following documents:

(a) Annotated provisional agenda (A/CN.9/WG.I/WP.49);

(b) Drafting materials addressing the use of electronic communications in public procurement, publication of procurement-related information, and abnormally low tenders: note by the Secretariat (A/CN.9/WG.I/WP.50);

(c) Drafting materials for the use of electronic reverse auctions in public procurement: note by the Secretariat (A/CN.9/WG.I/WP.51);

(d) Drafting materials for the use of framework agreements and dynamic purchasing systems in public procurement: note by the Secretariat (A/CN.9/WG.I/WP.52 and Add.1); and

(e) Issues arising from the use of suppliers' lists, including drafting materials: note by the Secretariat (A/CN.9/WG.I/WP.45 and Add.1) (the consideration of the note was deferred to a future session at the previous two sessions of the Working Group (see A/CN.9/595, para. 9, and A/CN.9/615, para. 10)).

11. The Working Group adopted the following agenda:

1. Opening of the session.
2. Election of officers.
3. Adoption of the agenda.
4. Consideration of proposals for the revision of the UNCITRAL Model Law on Procurement of Goods, Construction and Services.
5. Other business.
6. Adoption of the report of the Working Group.

III. Deliberations and decisions

12. At its eleventh session, the Working Group continued its work on the elaboration of proposals for the revision of the Model Law. The Working Group used the notes by the Secretariat referred to in paragraph 10 above (WP.50 and 51) as a basis for its deliberations. The Working Group held a preliminary exchange of views on document A/CN.9/WG.I/WP.52 and decided to consider the document in depth at its next session. It also deferred consideration of documents A/CN.9/WG.I/WP.45 and Add.1 and WP.52/Add.1 to a future session.

13. The Working Group requested the Secretariat to revise drafting materials contained in documents A/CN.9/WG.I/WP.50 and 51, reflecting the deliberations at its eleventh session, for its consideration at the next session. The Working Group noted that any time frame to be agreed for the completion of the project should take into account the time necessary to consider and address issues of conflicts of interest in revisions to the Model Law and the Guide. It was mentioned that the issue of conflicts of interest was an important issue in public procurement and it was recalled that at its tenth session the Working Group agreed to consider this issue as part of its current review of the Model Law and the Guide (A/CN.9/615, paras.11 and 82-85).

IV. Consideration of proposals for the revision of the UNCITRAL Model Law on Procurement of Goods, Construction and Services

A. Draft provisions addressing the use of electronic communications in public procurement (A/CN.9/WG.I/WP.50, paras. 4-42)

1. Communications in procurement: article [5 bis] (A/CN.9/WG.I/WP.50, paras. 4-21)

14. The Working Group confirmed its understanding that revisions to the Model Law and the Guide should be drafted in technologically neutral terms and that they should not, for example, specify or encourage any particular method of authentication. They should also impose essentially equal requirements on both the paper-based and the electronic procurement environment. Reference in this context was made to some provisions of the Guide, such as paragraph 3 of the commentary to article 30 (regarding the submission of tenders), which specified that, in the use of alternatives to traditional means and forms of submission, at least a similar degree of authenticity, security and confidentiality should be provided.

15. As regards paragraph (1) of the draft article, the Working Group decided to replace the words “described in” with the words “required by”, so as to limit the breadth of the provision. It was also agreed to retain the general reference in the paragraph to chapter VI of the Model Law (addressing Review), but with an explanation in the Guide that the article was intended to cover only information generated and communicated in the course of procurement. This provision would therefore exclude communications generated in court proceedings and in those administrative proceedings that may fall outside the scope of the Model Law.

16. As regards paragraph (2), it was agreed that the reference in the paragraph to article 12 (3) should be deleted, so that notice of the rejection of all tenders, proposals, offers or quotations would have to be communicated to all suppliers or contractors concerned in a form specified in paragraph (1). Noting the interdependence of paragraphs (1) and (2), it was also suggested that paragraph (2) should be expanded to cover any communication of information in a procurement that was generated other than pursuant to a requirement of the Model Law. It was also observed that all language versions of the text should refer to the obligation of a procuring entity to specify the means by which any requirements for writing, or for signature, or for both should be satisfied.

17. As regards paragraph (3), the Working Group agreed to add the words “for the purpose of procurement covered by this Law” after the word “shall”, to avoid the inadvertent application of the article to contract administration. The view was expressed, however, that such an addition might be superfluous in the light of clearly defined scope of the Model Law, which excluded the contract performance phase of procurement. In this regard, it was observed that the text would be reviewed in due course to ensure that there was no ambiguity in the reference to “procurement”.

18. As regards paragraph (4), it was agreed to replace the word “among” with the word “by”.

19. As regards paragraph (5), while agreeing to retain the wording proposed, the Working Group requested the Secretariat, in preparing an accompanying text for the

Guide, to make it clear that the requirement to secure the confidentiality of information would not apply to information that was intended to be made public under the Model Law.

20. With reference to paragraph 17 of the working paper, it was mentioned that the suggestion to use a definition instead of enumerating the list was a good idea. However, it was considered premature to make changes given that the text was not set.

2. Electronic submission of tenders: article 30 (5) (A/CN.9/WG.I/WP.50, paras. 22-29)

21. As regards subparagraph (a)(ii), it was agreed that the requirements should address “authenticity” and “security” in addition to “integrity” and “confidentiality” in the text, with explanation in the Guide of the meaning of each term in the context of that subparagraph.

22. As regards subparagraph (b), in response to the suggestion that the words “on request” should be deleted, concern was raised that the procuring entity might not be in a position in all cases to provide to a supplier or contractor a receipt showing the date and time when the tender was received (for example, when suppliers put tenders in a designated tender box without the procuring entity being aware of the submission). The view prevailed that since the policy objective in revisions of the Model Law and the Guide was to promote best practice, procuring entities should be required to provide to suppliers or contractors a receipt showing the date and time when the tender was received, in particular in the light of the importance of this information in review proceedings. The Working Group agreed therefore to delete the words “on request”.

23. As regards subparagraph (c), it was agreed that the text should include a requirement to preserve “security” in addition to “integrity” and “confidentiality”, with explanation in the Guide of the meaning of each term in the context of that subparagraph. Recognizing that the procuring entity could not generally preserve security, integrity or confidentiality before the receipt of tenders, it was also agreed that the phrase “from the time as determined by the procuring entity, but in no case later than the time of its receipt” should be deleted. Concern was raised that the reference to “authenticity” appeared in subparagraph (a)(ii) but not in subparagraph (c). It was argued that “authenticity” could only be ensured by the supplier and therefore the reference to “authenticity” should only appear in subparagraph (a)(ii).

24. The Working Group was informed that, in practice, in some cases, the precise time of receipt of paper-based tenders was not recorded, and recalling that more onerous requirements should not be placed on electronic submission, the Working Group considered how the time of receipt should be established and recorded. The Working Group noted that UNCITRAL Working Group IV (Electronic Commerce), when it worked on a draft convention on the use of electronic communications in international contracts, had encountered difficulties in defining the time of receipt of electronic communications. Recognizing that the characteristics of the electronic environment made it difficult to establish the time of receipt with precision, the solution adopted in the United Nations Convention on the subject¹ was that the time

¹ “United Nations Convention on the Use of Electronic Communications in International Contracts.” General Assembly resolution 60/21, annex.

of receipt of an electronic communication would be the time when an electronic communication became capable of being retrieved, presumed to be when it reached the addressee's electronic address.² It was agreed, therefore, that an element of discretion could be given to the procuring entity to establish the degree of precision to which the time of receipt of tenders submitted electronically would be recorded, and that the Guide should elaborate on that point.

3. Presence at the opening of tenders: article 33 (2) (A/CN.9/WG.I/WP.50, paras. 30-32)

25. The Working Group agreed with the proposed provisions in paragraph 30 of the working paper. It was also suggested that the Guide should note, as an example of the efforts to harmonize procurement texts, that the proposed text was consistent with similar provisions in other international instruments (such as World Bank procurement guideline 2.45³).

4. Publication of procurement-related information: article 5 and the publication of information on forthcoming procurement opportunities (A/CN.9/WG.I/WP.50, paras. 33-42)

Article 5

26. As regards paragraph (1), the Working Group agreed to replace the word "directives" with the words "other legal texts".

27. As regards paragraph (2), the Working Group agreed to open the paragraph with the phrase "notwithstanding the provisions of paragraph (1) of this article", to clarify that no category of text was intended to be included in both paragraphs, and to replace the proposed wording with the text reading "judicial decisions and administrative rulings with precedent value in connection with procurement covered by this Law shall be made available to the public and updated if need be."

28. The Working Group noted that all language versions of the proposed provisions should be aligned so that to draw a clear distinction between notions of making information accessible to the public (paragraph (1)) and making it available to the public (paragraph (2)).

29. It was agreed that the Guide should explain that, depending on legal traditions of enacting States, interpretative texts of importance to suppliers or contractors might be covered by either paragraph 1 or paragraph 2 of article 5, and the Secretariat was requested to address in this regard whether the phrase "judicial decisions and administrative rulings" would be sufficiently broad to cover all intended decisions and rulings.

Publication of information on forthcoming procurement opportunities

30. As regards proposed provisions on the publication of information on forthcoming procurement opportunities, contained in paragraph 37 of the working paper, the Working Group agreed: (i) to keep the word "promptly" without square brackets; and (ii) to split the provisions in two sentences. The understanding was

² Ibid., article 10 (2).

³ See in the "Guidelines Procurement under IBRD Loans and IDA credits", May 2004, revised 1 October 2006, available as of the date of this report at <http://siteresources.worldbank.org/INTPROCUREMENT/Resources/ProcGuid-10-06-ev1.doc>.

that the Secretariat should propose wording for the second sentence that would provide that publication of information on forthcoming procurement opportunities did not oblige the procuring entity to solicit tenders, proposals, offers, quotations or bids in relation to the publicised procurement opportunities.

31. As regards the location of the provisions, it was suggested that provisions should be placed in the beginning of the Model Law, as paragraph (3) of article 5, and the Secretariat would change the title of article 5 to reflect the addition of a new paragraph.

32. It was agreed that the Guide should note that publication of information on forthcoming procurement opportunities was optional, and in that context enacting States might wish to provide for publication of such information for procurements above a certain value.

B. Draft provisions addressing abnormally low tenders (A/CN.9/WG.I/WP.50, paras. 43-49)

Article 12 bis

33. The suggestion was made that the last sentence in the proposed paragraph 13 of the accompanying Guide text (A/CN.9/WG.I/WP.50, para. 49) should be removed from the Guide text and its substance should be reflected in draft article 12 bis. One proposal was that an amended extract from that sentence reading “the solicitation documents or other documents for solicitation of proposals, offers, quotations or bids shall include an explicit statement that a procuring entity may carry out analyses of potential performance risks and prices submitted” should be placed as a new paragraph (1) (a) of draft article 12 bis. Another proposal was that, in order to align draft article 12 bis (1) with provisions of article 12 (1) of the Model Law, paragraph (1) should be supplemented with a new subparagraph (a) reading: “[provided that] the procuring entity has specified the right to do so in the solicitation documents or in any other documents for the solicitation of proposals, offers or quotations.”

34. It was explained that the proposals were not intended to affect the right of the procuring entity to reject a tender under other articles of the Model Law or disqualify a supplier or contractor under articles 6 and 7 of the Model Law. The intention of the proposal was to require the express reservation of the right to reject an ALT under article 12 bis in the solicitation or equivalent documents.

35. Concerns were expressed about this proposal, in that in many jurisdictions and as a matter of general contract law, the procuring entity’s right to reject a tender or offer, whether on the ground that the price suggested was abnormally low or any other ground, was unconditional and remained so up to the time when the tender or offer was accepted by, and therefore became binding on, the procuring entity.

36. It was also suggested that article 12 (1) of the Model Law, in which the same precondition was imposed regarding the rejection of all tenders, should be reconsidered. For example, the article could provide that, while no obligation should be imposed on the procuring entity to reserve the right to reject all tenders in the solicitation or equivalent documents, the procuring entity should be required to justify its grounds for rejection of all tenders if it did not do so. Objections were raised to the suggestion that the Working Group should consider such revisions to

article 12 of the Model Law, as its approach represented a previously-negotiated and delicate balance between main legal systems, and should not be disturbed.

37. The Working Group decided to defer consideration of article 12 (1) to a later stage and to focus on the provisions of draft article 12 bis.

38. The first suggestion referred to in paragraph 33 above was subsequently amended by replacing the word “shall” with “may” or “should”, so that there was no requirement to reserve the right to reject ALTs in the solicitation documents. It was also proposed to locate the amended wording as a new paragraph (2) of draft article 12 bis. The desirability of including such a permissive provision in the Model Law was however questioned.

39. The Working Group decided to consider both suggestions, the first as amended (see the immediately preceding paragraph) and the second as originally proposed (see paragraph 33 above), at its next session.

40. Another suggestion for the draft article was to add as an opening phrase to paragraph (1) the words similar to the ones found in article 12 (1) “(Subject to approval by ... (the enacting State designates an organ to issue that approval))”. The view prevailed however that no such wording should be included, in particular in the light of the Working Group’s previous decision on that issue at its eighth session and of the reasons for that decision (A/CN.9/590, para. 109 (iii)).

41. The Working Group agreed that subparagraph (a) should be amended to make it clear that requests under that subparagraph were addressed to the supplier or contractor concerned.

Guide to Enactment

42. The Working Group agreed to make the following amendments to the draft text for the Guide that appeared following paragraph 49 of A/CN.9/WG.I/WP.50:

(a) To add the words “and it must substantiate its decision if it decides to reject a tender” at the end of the second sentence in paragraph (4), so as to ensure that the procuring entity’s concerns and reasons for those concerns would be recorded in writing;

(b) That the text in paragraph (8) in square brackets, qualifying the term “realistic”, should be deleted, because the qualification as drafted did not reflect the meaning of the term (whether or not there was a material performance risk). However, the Working Group agreed that some explanation of the term “realistic”, by reference to the constituent elements of the tender that would be evaluated as described in paragraph (7), should be included;

(c) That the last sentence of paragraph (9) should be deleted.

43. Also, as regards paragraph (9), it was noted that, should a supplier or contractor fail to provide the clarifications requested, the concerns of the procuring entity regarding potential performance risk would inevitably persist, giving a reason to the procuring entity to reject an ALT under subparagraph (b). It was noted however that the procuring entity would be obliged in any case to look at other, perhaps circumstantial information. The Working Group did not consider that further additions to the text would be necessary to reflect this point.

44. As regards paragraph (11), it was observed that the draft text at the end of the paragraph envisaged guidance on the operation of review proceedings in the context

of a rejection of an abnormally low tender, but no text was currently included pending a decision of the Working Group as to whether a decision to reject an abnormally low tender would be subject to review.

45. The Working Group therefore considered whether such a decision should indeed be subject to review. It recalled that, at its sixth session, the Working Group had decided on a preliminary basis that the list of exclusions from review contained in article 52 of the current Model Law text should be deleted (one effect being that a decision to reject all tenders under article 12 would then be subject to review). The importance of a consistent approach as regards the decisions within procurement that should be subject to review was also stressed, and thus it was observed that there should be a presumption that all stages of the procurement, including a decision to reject an ALT, should be subject to review.

46. The Working Group heard that many jurisdictions currently subjected any decision to reject an ALT to review, and that in some systems, a request for review could lead to the suspension of the procurement pending the outcome of the review. Noting that, by contrast with a rejection of all tenders under article 12, the rejection of an ALT would not of itself interrupt the procurement, some concern was expressed that suspension in the case of an ALT could unnecessarily interfere in the procurement. Further, it was noted that care should be taken to avoid any review taking the form of a *de novo* consideration as to whether or not the tender was abnormally low.

47. Observing that these issues would arise when considering article 52 and the review process as a whole, the Working Group decided to continue its deliberations in the context of its review of article 52 in due course. Those deliberations would proceed on the basis that there was wide support for the principle that a decision to reject an ALT should be subject to review.

48. As regards paragraph (12), the Working Group noted the educational purpose of the provisions contained therein. The Secretariat was requested to reconsider the paragraph in the light of the distinct issues it addressed, such as assessment of qualifications of suppliers or contractors and evaluation of tenders. It was suggested that appropriate cross-references to the relevant provisions of the Model Law and sections of the Guide might be included.

49. As regards paragraph (13), it was agreed that the last sentence of the paragraph should be removed in the light of the relevant amendments proposed to draft article 12 bis (see paragraphs 33 to 39 above).

C. Draft provisions to enable the use of electronic reverse auctions in public procurement under the Model Law (A/CN.9/WG.I/WP.51)

1. General comments

50. The importance of the Working Group's work on ERAs was highlighted. It was mentioned that in the absence of detailed regulation of the subject at national, regional or international level, UNCITRAL should set the standard in the use of that procurement technique, which could then be used internationally. It was noted that detailed regulation of the subject at an international level would benefit both jurisdictions that were experienced in the use of that procurement technique as well as those jurisdictions that were considering introducing it.

51. The Working Group noted general provisions on the subject included in the revised (December 2006 version) Agreement on Government Procurement of the World Trade Organization.⁴ The point was made that since those provisions were formulated as general principles, they would benefit from the detailed guidance that UNCITRAL could provide.

2. Conditions for the use of electronic reverse auctions: draft article 22 bis (A/CN.9/WG.I/WP.51, paras. 6-13)

52. The view was shared, in the light of the novelty of ERAs and regulation in the field, that an article on conditions for the use of ERAs should establish the essential minimum conditions. So doing would allow both jurisdictions not familiar with the procurement technique properly to introduce and to use it, and would not prevent those jurisdictions that were already using the technique to continue with and refine its use.

53. The Working Group agreed: (i) to replace in the chapeau of the draft article the word “circumstances” with the word “conditions”; (ii) to keep subparagraphs (a) and (b) in the text of the Model Law but to remove subparagraph (c) to the Guide, with an explanation of the meaning of “construction and services of a simple nature”; (iii) to highlight in the Guide (with a possible cross-reference to article 16 (2)) the need for the procuring entity, in formulating detailed and precise specifications for the goods[, construction or services], to use the relevant objective technical and quality characteristics of the goods[, construction and services] procured; and (iv) amend subparagraph (d) to read as follows “Where the price is the only criterion to be used in determining the successful bid. The procurement regulations may establish conditions for the use of electronic reverse auctions in procurement where other criteria that can be expressed in monetary terms may be used in determining the successful bid.” (For further drafting suggestions made to draft article 22 bis, see paragraphs 62 (b) and 69 to 72 below).

54. The understanding in the Working Group was that subparagraph (d) as amended was intended to provide for two versions of ERAs: those in which price was the only criterion to be used by the procuring entity in determining the successful bid (referred to as alternative A in paragraph 18 of the working paper) and those in which non-price criteria were evaluated at a pre-auction stage (referred to as alternative C in the same paragraph). The Working Group’s attention was drawn to an example of regulation in one state that followed this formulation. No consensus was reached on whether the Model Law or the Guide should provide for alternative B as it stood. Concerns were expressed that alternative B contained inherently non-transparent mechanisms for the expression of non-price criteria in monetary terms (for their subsequent automatic evaluation through the auction). However, some delegates shared the view that, in order to preserve flexibility and given the different procedural consequences of the two alternatives, elements of alternative B should be retained in alternative C. (For further discussion of the relevant provisions, see paragraphs 63 to 72 below).

55. Doubts were expressed as to desirability of retaining references to construction and services in the text of the draft article. The view prevailed however that, as was

⁴ See articles I (e) and XIV of the revised text. The revised text has been circulated among all WTO members as document GPA/W/297, available as of the date of this report at www.wto.org/english/tratop_e/gproc_e/gp_gpa_e.htm.

agreed at the previous session (A/CN.9/615, para. 41), such references should be maintained in the text in square brackets, and the Guide would elaborate on the advantages and concerns that might arise in the use of ERAs for construction and services procurement.

56. The point was also made that referring to a requirement to ensure effective competition only in the context of ERAs (subparagraph (b)) might imply that similar considerations were not valid in the context of other procurement methods or techniques. The Working Group agreed to revisit the issue at a future time.

3. Procedures in the pre-auction and auction stages: draft articles 51 bis to septies (A/CN.9/WG.I/WP.51, paras. 14-59)

Draft article 51 bis. General provisions (A/CN.9/WG.I/WP.51, paras. 14-18)

57. The view was expressed that the draft article should be amended so as to provide for the use of ERAs only as a stand-alone procurement method, with explanation in the Guide that ERAs could be used in conjunction with some procurement methods. It was pointed out that the use of ERAs in some procurement methods referred to in the draft article as well as in tendering proceedings would be inappropriate due to the particular characteristics of those procurement methods (such as prohibition in tendering proceedings of substantive modification of tenders after their submission). It was also stated that the lack of practical experience with regulation and use of ERAs as a phase in procurement methods made regulating such use difficult, and the Guide should alert enacting States accordingly. It was noted that ERAs could more appropriately be envisaged in framework agreements.

58. Concerns that ERAs could be used in all procurement methods referred to in the draft article were shared. It was, however, pointed out that the agreement reached at the previous session (A/CN.9/615, para. 50) was that ERAs could be used not only as a stand-alone procurement method but also in conjunction with existing procurement methods, as and when appropriate. The importance of preserving flexibility in that regard was stressed. In response to concerns about the lack of practical experience with regulation and use of ERAs as a phase in procurement methods, it was stated that UNCITRAL, as part of its mandate to harmonize and modernize the law of international trade, should not only codify existing practices but should also contribute to their development.

59. Some support was expressed for the suggestion to delete the draft article as it did not add anything to the provisions in immediately following articles 51 ter and quater. Another suggestion was that, instead of specifying in which procurement methods ERAs might be used, the draft article should provide for their possible use in other procurement methods set out in the Model Law, as might be appropriate in the light of the conditions for use of those procurement methods and ERAs. Alternatively, the provisions could cross-refer to the articles that would define such methods.

60. The Working Group noted the experience of some jurisdictions in regulating ERAs and their practical use in various ways, including as a phase in procurement methods. Particular reference in this regard was made to the note by the Secretariat containing a study on the topic (A/CN.9/WG.I/WP.35 and Add.1).

61. The Working Group decided to defer its consideration of the draft article to a later stage. (For further discussion, see paragraph 77 below).

Draft article 51 ter. Pre-auction procedures in stand-alone electronic reverse auctions (A/CN.9/WG.I/WP.51, paras. 19-34)

62. The following drafting suggestions were made:

(a) In paragraph (1), to cross-refer to article 24 of the Model Law;

(b) In subparagraph (b) of paragraph (2), to retain only those elements of information regarding the evaluation process that were essential to ensure transparency and predictability in the process. It was agreed that the subparagraph would provide that the notice of an ERA should include a statement of the criteria to be used by the procuring entity in determining the successful bid, such as whether price and other criteria would be so used, or price alone, and the relative weight assigned to the criteria. The notice would also state explicitly which, if any, of the non-price criteria would be evaluated prior to the auction and would not subsequently be varied during the auction itself, and the mathematical formula that would be used in the evaluation procedure. It was also agreed that non-essential elements should be reflected elsewhere, such as in draft article 22 bis to supplement subparagraph (d) (see further paragraphs 69 to 72 below);

(c) To delete subparagraph (c) in paragraph (2). In this regard, a reference was made to subparagraph (j) that referred to rules for the conduct of the ERA (which should contain the information referred to in subparagraph (c)). The view prevailed that subparagraph (c) should remain since the rules for the conduct of the ERA might not necessarily contain such information, which was considered important for ensuring adequate competition and transparency in the process;

(d) In subparagraph (f) of paragraph (2), to replace the phrase the “[website or other electronic] address” with the word “location” and to refer to the website or other electronic address as examples of the location at which the ERA may be held in the Guide. Various alternatives were suggested for the opening phrase of that subparagraph, including “electronic site” and “where the electronic reverse auction will be held”. The view prevailed that the beginning of paragraph 2 (f) should read “how the electronic reverse auction can be accessed”;

(e) To replace the word “known” in subparagraphs (g), (h) and (i) of paragraph (2) with the word “determined”. This suggestion was accepted. However, the point was made that some information referred to in these subparagraphs should be determined and made known to suppliers or contractors by the procuring entity at the beginning of the procurement proceedings (i.e., in the notice of the ERA) and therefore the use of the phrase “if already determined” with reference to this kind of information might not be appropriate. The Secretariat was requested to reformulate the paragraphs, so that information that should be determined at the beginning of the procurement proceedings be expressly included without qualification;

(f) To merge subparagraphs (j), (k) and (l) of paragraph (2) to read as follows: “The rules for the conduct of the electronic reverse auction, including the information that will be made available to the bidders in the course of the auction and the conditions under which the bidders will be able to bid.” The proposal was accepted; and

(g) To delete paragraph (9). The view however prevailed that the paragraph should remain as an important element in ensuring predictability, objectivity and transparency in the process, and as a safeguard for suppliers or contractors against possible improprieties by procuring entities (such as manipulating the date and time of the auction opening to favour some suppliers).

63. In the context of consideration of paragraph 2 (b), various proposals were heard, including that provision should be made for price-based ERAs only in the Model Law (discussing the potential use of more complex ERAs only in the Guide) (alternative A); for price and non-price based criteria that would be evaluated only during the auction (alternative B); and making provision for price and non-price based ERAs, but the non-price based criteria could be evaluated either before or during the auction (alternative C). The Working Group was informed that there were no known examples of alternative B in systems that had been reviewed to date.

64. The Working Group recalled that one aim of the draft provisions contained in the working paper was to enable enacting States to select one of the three alternatives. The potential benefits and disadvantages of each alternative were discussed, with emphasis on the need to ensure adequate competition and transparency in the operation of ERAs, to avoid potential abuse, and to reflect and provide for best practice in the light of limited experience.

65. Concerns were reiterated as regards allowing non-price criteria to be used in ERAs. The Working Group noted the cautious approach taken by the World Bank towards ERAs, especially towards allowing the use of any non-price criteria in ERAs and using that tool for types of procurement beyond procurement of simple standardized goods. The point was made that in a Guide text accompanying provisions of the Model Law on ERAs, these concerns and grounds for them should be stressed.

66. The prevailing view was that both price and non-price criteria could be used in ERAs under the Model Law, in such a manner that enacting States could select any or both alternatives. (It was noted that the Guide would present the advantages and disadvantages of each option or recommend the use of ERAs where price was the only award criterion, or both. No consensus on this point being reached at this session, the Working Group agreed to reconsider the question at its next session.) It was also observed that it would not be necessary to separate the alternatives, and to provide for conditions for the use of price only and price and non-price based ERAs in one place would be a better approach.

67. It was emphasized that the Guide would need to provide detailed and practice-based guidance on the selection of appropriate alternatives for any enacting State. The Guide should explain what each variant of ERA entailed (advantages, disadvantages, challenges and the required level of expertise and experience, for example properly to factor any non-price criteria in a mathematical formula) and the risks of introducing subjectivity into the process. It was pointed out that more complex ERAs would require the higher level of expertise and experience in dealing with them in an enacting State and its procuring entities. Even those procuring entities that were supervising activities of third party service providers handling ERAs on behalf of procuring entities would require such expertise and experience.

68. As regards the use of ERAs involving non-price criteria, it was agreed that it was critical to ensure in the Model Law's provisions that the criteria should be transparent and objective, and transparently and objectively applied, and thus that they should be quantifiable and expressed in monetary terms. In addition, it was stressed that the provisions for ERAs should note that in the ERAs involving non-price criteria, price would always remain one of the determining criteria, so that ERAs could never be based on other criteria alone and the price would always be subject to the auction. The view was expressed that definition of an ERA (for example drawing on that in the GPA) might be included to reflect this point.

Recalling the consensus in the Working Group reached at the previous session that no such definition should be included in the Model Law, the Working Group decided to consider at a later stage whether an express reference in the provisions governing the conduct of the auction itself (draft article 51 *sexies*) would be sufficient.

69. Accordingly, it was agreed that the conditions in draft article 22 bis (d) for use of ERAs should be revised, to provide that ERAs could involve either the price as the only evaluation criterion or price and other criteria. It was noted that it would have to be determined in advance (and fully reflected in the notice of the ERA to be published) whether the ERA would be price-based or price and other criteria-based, and whether all, some or none of those non-price criteria would subsequently be evaluated in the auction itself. The determination would also include the identification of all other non-price criteria concerned, and the relative weight of all such criteria (including the criteria used to determine the weighting, to be expressed in an objective manner and in monetary terms).

70. It was queried whether the conditions for use should require the submission of initial bids for all ERAs in which both price and non-price criteria would determine the successful bid. This question was subject to lengthy discussion, focusing on the two ways in which the non-price criteria could form part of the determination of the successful bid: that is, as criteria that could be evaluated during the auction or as criteria that were evaluated prior to the auction. It was agreed that initial bids would naturally be required in the latter case, and that the evaluation prior to the auction might lead to a ranking of the bids.

71. Views, however, differed as to whether there was a real benefit to a pre-auction evaluation if all criteria would subsequently be evaluated during the auction. On the one hand, it was said that such an evaluation would be an important step in ensuring the transparency of the application of the criteria and weightings, as it would be followed by a notice to each bidder of the results of that evaluation (the results including whether the bidder was qualified for the ERA, whether the initial bid was responsive, and, if relevant, any ranking or scoring of the bid). This procedure would enable a challenge or review of the criteria or their application before the auction took place. On the other hand, certain delegations expressed the view that there was little real benefit if suppliers could change all elements of their bids during the auction.

72. Noting also that the 2004 European Union procurement directives required the submission of initial bids, their evaluation and the subsequent advising of bidders of the outcome of that evaluation,⁵ the prevailing view was that the use of any ERA involving both price and non-price criteria should be subject to the condition that initial bids should be submitted and evaluated, and the results should be communicated to each supplier or contractor concerned. The Working Group therefore decided that conditions in draft article 22 bis (d) should also contain this requirement. It was also recalled that a critical anti-abuse feature of ERAs was that

⁵ See article 56 of Directive 2004/17/EC of the European Parliament and of the Council of 31 March 2004 coordinating the procurement procedures of entities operating in the water, energy, transport and postal services sectors, and article 54 of Directive 2004/18/EC of the European Parliament and of the Council of 31 March 2004 on the coordination of procedures for the award of public works contracts, public supply contracts and public service contracts, both available as of the date of this report at http://ec.europa.eu/internal_market/publicprocurement/legislation_en.htm.

the anonymity of bidders should be preserved throughout the process, and therefore the results of the evaluation of each bid would be communicated only to the bidder concerned.

73. The Working Group agreed to delete the words “or partial” before the word “evaluation” in paragraphs (2) (e)(ii), and 6 (c). It also agreed to replace the reference to two working days in paragraph (9) with a reference to “adequate time, which is sufficiently long to allow suppliers or contractors to prepare for the auction,” as suggested in the end of paragraph 34 of the working paper.

Draft article 51 quater. Pre-auction procedures in procurement by means of restricted tendering, competitive negotiation or request for quotations (A/CN.9/WG.I/WP.51, paras. 35-37)

74. The view was generally shared that the draft article should not refer to any specific procurement method set out in the Model Law in which ERAs might be used as the manner of determining the successful bid. It was preferred that the article should state generally that, as long as the objectives of the Model Law were preserved, and conditions and procedural requirements both for the use of ERAs and for the use of procurement methods set out in the Model Law were compatible, ERAs might be used in those procurement methods.

75. The view was reiterated that, in the absence of sufficient experience in regulating ERAs and their use as a phase in procurement methods, a flexible approach, and regulation at the general level, would be appropriate. Otherwise, it was stated, regulations formulated in unnecessarily prescriptive terms or in too much detail might turn out to be unworkable in practice. The point was also made that any explicit exclusion of the use of ERAs in a specific procurement method, or any omission of a reference to any procurement method in which ERAs might be used, might result in incompatibility of the provisions of the revised Model Law and the Guide with other regional or international instruments that envisaged the use of ERAs in those procurement methods (for example, the 2004 European Union procurement directives that allowed the use of ERAs in open, restricted and negotiated procedures⁶).

76. The Working Group agreed to proceed on this basis. It was also agreed that, in revising the draft article, the Secretariat should retain the requirement that the procuring entity should disclose, at the solicitation stage, the fact that ERAs would be used to determine the successful bid in the procurement proceedings. Recognizing difficulties with introducing ERAs as a phase in some procurement methods, the Guide accompanying the relevant provisions would explain how ERAs might be incorporated in various procurement methods, and which modifications of traditional characteristics of those procurement methods would be needed (an example would be that the current Model Law did not envisage repetitive submission of tenders, offers or quotations, which would have to be adjusted to accommodate the use of ERAs).

77. The Working Group agreed to delete draft article 51 bis as a result of these amendments to draft article 51 quater.

⁶ Ibid.

*Draft article 51 quinquies. Requirement of effective competition
(A/CN.9/WG.I/WP.51, paras. 38-41)*

78. Observing that the draft article dealt only with some means that aimed at ensuring effective competition in ERA, the Working Group agreed that the title of the draft article should be changed to read “Requirement of sufficient number of bidders to ensure effective competition.”

79. The need for the draft article was questioned since the requirement of effective competition was already included in paragraph (b) of proposed article 22 bis. In response, it was noted that the conditions for use of ERAs contained in draft article 22 bis (b) required the existence of a competitive market as a precondition for the use of the ERA, but did not address how to ensure effective competition during the conduct of the procurement involving the ERA itself. The prevailing view was that the draft article was important and should remain.

80. In response to concerns that the requirement in paragraph (1) was onerous since the procuring entity would not have means to ensure effective competition at all stages of the ERA, it was observed that the paragraph addressed the stage of the procurement at which the procuring entity issued invitations to potential bidders, and therefore it would be within the control of the procuring entity to ensure that the number of suppliers or contractors invited to participate in the auction was sufficient to secure effective competition.

81. It was decided that paragraph (1) should be retained with some amendments to reflect the revisions that would be made to article 51 quater (see paragraphs 74 to 76 above).

82. As regards paragraph (2), it was agreed to replace the term “withdraw” with the term “cancel” since the former was used in the Model Law in a different context (that is, in the context of withdrawal of tenders under article 31). It was also agreed that the word “shall” in square brackets should be replaced by “may”, to provide flexibility to the procuring entity in dealing with situations where the number of suppliers or contractors registered to participate in the auction was insufficient to ensure effective competition (for example, the procuring entity in such a situation might consider extending a deadline for registration to participate in the auction).

83. Concerns were expressed that the draft article did not address how a procuring entity should proceed if the ERA was cancelled as a result of insufficient number of registered bidders to ensure effective competition. It was suggested that options could be provided in the Model Law, for example that the procuring entity could proceed to negotiate with potential suppliers. Observing that the 2004 European Union procurement directives⁷ also did not provide a solution to this issue, and noting that the question involved practical considerations, it was commented that the procuring entity should be afforded some flexibility in this regard and should not be obliged to continue with the procurement in these circumstances. It was stated that the procuring entity might be able to proceed in various ways, all of which could not be envisaged and regulated in the Model Law, and therefore the Guide could illustrate some options and mention that solicitation or equivalent documents might set out any steps that the procuring entity intended to take should the situation arise.

⁷ Ibid.

Draft article 51 sexies. Requirements during the auction (A/CN.9/WG.I/WP.51, paras. 42-49)

84. As regards paragraph 1 (c), the Working Group agreed to omit the reference to ranking of the bidders and to refer only to successive results of the auction, which would be the price in ERAs where price was the only evaluation criterion, or otherwise the outcome, expressed in a figure, of the application of the pre-disclosed evaluation criteria (including the mathematical formula). It was agreed to replace the phrase “[according to the pre-disclosed formula]” with the phrase “according to pre-disclosed evaluation criteria”.

85. As regards paragraph (2), the Working Group agreed to delete the sentence in the square brackets that referred to articles 33 (2) and (3) of the Model Law, which referred to tendering proceedings and would no longer be relevant. As regards the issue in the same paragraph on whether the anonymity of bidders should be preserved after the auction, the view prevailed that the paragraph should be redrafted to reflect the following understanding of the Working Group: (i) the anonymity of bidders had to be preserved during the auction, and in the case of suspension or termination of the auction; and (ii) where the auction was successful and the winner known, the name of the winner and its address as well as information about the winning price would have to be communicated to other bidders, as envisaged in paragraph (3) of draft article 51 septies.

86. Views varied as to the practical value of the disclosure of the names of other bidders after the closure of the auction. Reference in this regard was made to articles 11 (1) and (2) of the Model Law, in which it was provided that this type of information was to be reflected in the records of procurement proceedings and to be made available to any person on request. The value of disclosing such information was emphasized as a general matter of transparency in the procurement process, and in particular as a means to verify that the procuring entity had complied with the requirement to ensure effective competition, as envisaged in draft articles 22 bis and 51 quinquies.

87. The view prevailed that the names of all bidders could be disclosed only if such disclosure would not result in the disclosure of price-sensitive commercial information regarding any particular bidder. That latter requirement was considered to be especially important for preventing collusion, protecting legitimate commercial interests of the bidders and thus maintaining competitiveness in the market and ensuring the success of future auctions. It was also noted that the introduction of ERAs as a new procurement tool would be successful only to the extent that potential bidders had sufficient confidence in the process, in particular that price-sensitive information about their business would be kept confidential through ERAs; otherwise, it was said, they would be reluctant to take part in procurement proceedings that involved ERAs. These considerations, it was pointed out, should prevail over transparency considerations.

88. It was suggested that the Guide should provide guidance to the enacting State and its procuring entities as regards situations and grounds that would justify keeping information relating to bids confidential. Reference in this regard was made to the provisions of article 11 (3) of the Model Law, which gave exceptions to disclosure of portions of the records of the procurement proceedings relating to detailed information on the examination, evaluation and comparison of submissions, as well as disclosure of records if such disclosure would inter alia inhibit fair competition or would prejudice legitimate commercial interests. It was noted that

risks of anti-competitive effect of such disclosure was particularly high when a small number of bidders took part in the ERA.

89. As regards paragraph (4), the Working Group considered whether the provisions should provide for possibility to suspend or terminate the ERA in cases other than system or communications failures. The views were expressed that, in the light of practical experience, suspension might be desirable in the case of suspected abnormally low bids. In such case, it was said, there should be the means available to the procuring entity instantaneously to intervene to the process to prevent any disruptive effect that the abnormally low bid might have on the auction (such a bid might have the effect of preventing other bidders from continuing to participate). The Working Group also took note, with reference to paragraph 49 of the working paper, that complaints from bidders about irregularities in the process might be made, which might also justify suspension of the auction. The Secretariat was requested to redraft the paragraph taking into account these considerations. The view was shared that provisions should be redrafted also to make it clear that the procuring entity was not responsible for failures in the bidders' communication systems, and such failures would not justify the suspension of the ERA.

Draft article 51 septies. Award of the procurement contract on the basis of the results of the electronic reverse auction (A/CN.9/WG.I/WP.51, paras. 50-57)

90. It was noted that the draft article had been prepared on the basis of provisions previously presented to the Working Group, and were intended to be equivalent to those governing the award of the procurement contract, and relevant exceptions, in tendering proceedings.

91. In this regard, it was queried whether the full text of paragraph (1) of the draft article was necessary, or whether, more simply and concisely, references to article 36 and to other relevant articles could be used. In response, it was observed that article 36 applied only to tendering proceedings, and that a separate article on award of contracts in the specific context of ERAs was necessary. It was decided that paragraph (1) should be retained but simplified and shortened to the extent possible, for example by the greater use of cross references rather than a restatement of text that appeared elsewhere in the Model Law.

92. It was observed that the following changes should be made to the text: (i) in the chapeau of paragraph (1), the phrase "ranked first" should be replaced with the phrase "the lowest evaluated bid", to reflect changes proposed to draft article 51 sexies (1) (c) (see paragraph 84 above); and (ii) in paragraph (1) (b), the square brackets around "article 12 bis" should be removed.

93. It was noted that paragraph (2) addressed the options available to the procuring entity should the successful bidder not enter into a procurement contract by reason of the circumstances set out in paragraph (1), and presented a more flexible approach than that previously considered by the Working Group. The Working Group agreed with the flexible approach, noting, however, that the words "second lowest price" and "ranked second" in paragraph (2) (c) should be replaced with the words "next lowest price" and "next lowest evaluated bid", respectively.

94. It was agreed that the practical implications of each option would require elaboration in the Guide. The Working Group considered that the Guide, prior to addressing the options available, should emphasize the need for prompt action where there was any post-auction qualification of the successful bidder or a review

of a possible abnormally low bid, so as to ensure that the final position should be determined as soon as reasonably practical.

95. As regards paragraph (3), it was agreed that square brackets therein should be removed and the reference to “accepted bid” should be replaced by the phrase “the bid that the procuring entity is prepared to accept”.

96. The Working Group agreed to finalize the wording of the draft article after it had considered revisions to article 36 of the current Model Law in due course.

**4. Consequential changes to other provisions of the Model Law
(A/CN.9/WG.I/WP.51, paras. 60-69)**

97. In the course of discussion of paragraphs 60 to 67 of the working paper, the Working Group agreed that issues related to the content of solicitation documents, period of effectiveness, modification and withdrawal of tenders, bid securities, and examination, evaluation and comparison of tenders, should be addressed in the context of provisions on ERAs as and where appropriate through cross-references to the relevant articles of the Model Law.

98. As regards the specific issue of withdrawal of bidders from the ERA before its closure, the Working Group noted that there might not be readily available solutions to that problem. Blacklisting of suppliers who withdrew was not considered to be a viable option, since it was often not possible to determine the reasons for an early withdrawal and the reasons for such a withdrawal might be justifiable. Recognizing that withdrawal of bidders might have a negative impact on effective competition, the Working Group considered whether the procuring entity should have the right to suspend or terminate the auction when an insufficient number of bidders participated in the auction. Reference in this regard was made to paragraph (4) of draft article 51 *sexies*, which could be expanded so as to refer to other justifiable reasons as grounds beyond system or communication failures for the suspension or termination of an ERA. Noting that suspension or termination of an ERA for reasons other than system or communication failure might lead to challenges by affected bidders, and might be counterproductive in preventing last-minute competition (a common feature of ERAs), the view prevailed that draft articles 51 *quinquies* and *septies* were sufficient to deal with the issue.

99. As regards the specific issue of bid securities, noting that some jurisdictions required bid securities in the context of ERAs, in particular to alleviate risks of fraudulent bids, and also noting various circumstances that might justify a request for bid security, the Working Group agreed that the Guide should not discourage recourse to bid securities.

100. As regards paragraph 68 of the working paper, the Working Group agreed that the proposed text for the Model Law should be expanded to refer to all information that would have to be included in the record of procurement proceedings in the context of an ERA, which was not expressly mentioned in article 11 (1) of the Model Law. It was suggested in particular that records should contain information about the grounds and circumstances on which the procuring entity relied to justify recourse to the ERA, and the date and time of the ERA. It was also considered justifiable to provide exceptions to disclosure of some type of information under article 11 in the light of specific characteristics of the ERA.

D. Draft provisions to enable the use of framework agreements in public procurement under the Model Law (A/CN.9/WG.I/WP.52)

General comments

101. The Working Group considered the draft provisions to enable the use of framework agreements in public procurement under the Model Law presented in document A/CN.9/WG.I/WP.52, noting in particular the scope of the draft provisions and the approach to drafting contained in that document. It was agreed that the Working Group's deliberations on the topic would be continued at its next session, including on the following issues highlighted as of importance to the debate:

(a) How to provide for appropriate nomenclature for this procurement technique, especially given the different terms used in various jurisdictions and systems;

(b) Whether a framework agreement and/or a purchase order under a framework agreement should constitute the procurement contract under the Model Law. In this regard, it was observed that whether framework agreements themselves would constitute binding contracts would be a question of local law in any particular state, that it would be vital to ensure a common understanding on the optimal solution, and that the terms and conditions of a framework agreement should in any event be clear and transparent. It was also noted that the Guide should discuss the issue in detail;

(c) The related question of whether or not a procuring entity should be able to procure outside the framework agreement, which was noted to be a multi-faceted one, and the different experiences in various jurisdictions would need to be considered;

(d) Whether a multi-supplier framework agreement should take the form of one contract for all suppliers that were parties to the framework agreement, or whether each party should have a separate contract with the procuring entity;

(e) Whether the framework agreement should be open to additional suppliers or contractors during its term; and

(f) Whether provision should be made for a Model 2 framework⁸ (normally envisaged to be a multi-supplier agreement) to be concluded with a single supplier, for example in the case of urgent procurement or a catastrophic event.

E. Simplification and standardization of the Model Law

102. The Working Group also considered the question of standardization and simplification of the Model Law by reference to the example of article 36 of the Model Law (noting that article 36 addressed the entry into force of procurement contracts in tendering proceedings). It was noted that the provisions governing the acceptance of successful submissions and the entry into force of the procurement contract (as set out in article 13 of the Model Law) were slightly different under different procurement methods. The need for consistency in these matters was accepted, in particular in the context of introducing ERAs as a possible technique in

⁸ See description of the models of framework agreements in paragraph 6 of A/CN.9/WG.I/WP.52.

a variety of procurement methods, and as a method itself. It was also stated that these matters, and perhaps other steps described in the tendering process under the Model Law, might be considered to be issues that should be addressed from the perspective of general rules applicable to all procurement methods. Accordingly, the Working Group agreed that it would consider the steps in the tendering process, including article 36, from this perspective at a future time.

E. Note by the Secretariat on revisions to the UNCITRAL Model Law on Procurement of Goods, Construction and Services — drafting materials addressing the use of electronic communications in public procurement, publication of procurement-related information, and abnormally low tenders, submitted to the Working Group on Procurement at its eleventh session
(A/CN.9/WG.I/WP.50) [Original: English]

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I. Introduction

1. The background to the current work of Working Group I (Procurement) on the revision of the UNCITRAL Model Law on Procurement of Goods, Construction and Services (the “Model Law”) (A/49/17 and Corr.1, annex I) is set out in paragraphs 5 to 65 of document A/CN.9/WG.I/WP.49, which is before the Working Group at its eleventh session. The main task of the Working Group is to update and revise the Model Law, so as to take account of recent developments, including the use of electronic communications and technologies, in public procurement.

2. The regulation of such use, including in the context of the submission and opening of tenders, holding meetings, storing information and publicising procurement-related information, was included in the topics before the Working Group at its sixth to tenth sessions. At its tenth session, the Working Group requested the Secretariat to revise the draft provisions on the use of electronic communications in public procurement that it had considered at the session.¹ This note has been prepared pursuant to that request, and sets out the relevant draft provisions that reflect the Working Group’s deliberations at its tenth session (see paragraphs 4-42 below).

3. This note also contains draft provisions for the Model Law and the Guide addressing abnormally low tenders (“ALTs”), revised pursuant to the Working Group’s request at its tenth session (see paragraphs 43-49 below).

II. Draft provisions addressing the use of electronic communications in public procurement

A. Communications in procurement

1. Proposed draft text for the revised Model Law

4. The following draft article draws on a consolidated text of draft article 5 bis that was before the Working Group at its tenth session² and reflects the suggestions made to that text at that session.³

“Article [5 bis]. Communications in procurement

(1) Any document, notification, decision and other information generated in the course of a procurement and communicated as described in this Law, including in connection with review proceedings under [chapter VI] [article 53] or in the course of a meeting, or forming part of the record of procurement proceedings under article [11], shall be in a form that provides a record of the content of the information and that is accessible so as to be usable for subsequent reference.

(2) Communication of information between suppliers or contractors and the procuring entity referred to in articles [7 (4) and (6), 12 (3), 31 (2)(a), 32 (1)(d), 34 (1), 36 (1), 37 (3), 44 (b) to (f) and 47 (1), to update for revisions

¹ A/CN.9/615, para. 11.

² Ibid., para. 18.

³ Ibid., paras. 19-26.

to *Model Law*] may be made by means that do not provide a record of the content of the information on the condition that, immediately thereafter, confirmation of the communication is given to the recipient of the communication in a form that provides a record of the content of the information and that is accessible so as to be usable for subsequent reference.

(3) The procuring entity, when first soliciting the participation of suppliers or contractors in the procurement proceedings, shall specify:

(a) Any requirement of form in compliance with paragraph (1) of this article;

(b) The means to be used to communicate information by or on behalf of the procuring entity to a supplier or contractor or to the public or by a supplier or contractor to the procuring entity or other entity acting on its behalf;

(c) The means to be used to satisfy all requirements under this Law for information to be in writing or for a signature; and

(d) The means to be used to hold any meeting of suppliers or contractors.

(4) The means referred to in the preceding paragraph shall be readily capable of being utilized with those in common use among suppliers or contractors in the relevant context. The means to be used to hold any meeting of suppliers or contractors shall in addition ensure that suppliers or contractors can fully and contemporaneously participate in the meeting.

(5) Appropriate measures shall be put in place to secure the authenticity, integrity and confidentiality of information concerned.”

Commentary

Paragraph (1)

5. Paragraph (1) sets out the substantive requirements of form of communications in procurement. They may be derogated from only in accordance with paragraph (2) of the draft article.

6. The procuring entity must set out any specific form requirement when it first solicits the participation of suppliers or contractors in the procurement proceedings, in accordance with paragraph 3 (a) of the draft article. Such specific requirements have to comply with general requirements in paragraph (1) of the draft article.

7. The references in paragraph (1) to [chapter VI] [article 53] are put in square brackets to indicate that it may be inappropriate in the context of the article to refer to the entire chapter VI on review, which includes provisions on administrative and judicial reviews. Administrative review and court proceedings are likely to have their own rules for communications. The paragraph may therefore more appropriately refer only to article 53 that addresses review by a procuring entity.

Paragraph (2)

8. Paragraph (2) sets exceptions to the rule contained in paragraph (1) that the form of information has to provide a record of the content of the information.

The list of the articles referred to in that paragraph is taken from the current paragraph (2) of article 9 of the Model Law.

9. The Working Group may wish to consider whether it would be appropriate to retain references to all the listed articles. For the ease of reference, the text of those articles is reproduced in the table below:

<i>Article</i>	<i>Content</i>
7 (Prequalification proceedings)	<p>(4) The procuring entity shall respond to any request by a supplier or contractor for clarification of the prequalification documents that is received by the procuring entity within a reasonable time prior to the deadline for the submission of applications to prequalify. The response by the procuring entity shall be given within a reasonable time so as to enable the supplier or contractor to make a timely submission of its application to prequalify. The response to any request that might reasonably be expected to be of interest to other suppliers or contractors shall, without identifying the source of the request, be communicated to all suppliers or contractors to which the procuring entity provided the prequalification documents.</p> <p>(6) The procuring entity shall promptly notify each supplier or contractor submitting an application to prequalify whether or not it has been prequalified and shall make available to any member of the general public, upon request, the names of all suppliers or contractors that have been prequalified. Only suppliers or contractors that have been prequalified are entitled to participate further in the procurement proceedings.</p>
12 (3) (Rejection of all tenders, proposals, offers or quotations)	<p>Notice of the rejection of all tenders, proposals, offers or quotations shall be given promptly to all suppliers or contractors that submitted tenders, proposals, offers or quotations.</p>
31 (2)(a) (Period of effectiveness of tenders; modification and withdrawal of tenders)	<p>Prior to the expiry of the period of effectiveness of tenders, the procuring entity may request suppliers or contractors to extend the period for an additional specified period of time. A supplier or contractor may refuse the request without forfeiting its tender security, and the effectiveness of its tender will terminate upon the expiry of the unextended period of effectiveness;</p>
32 (1)(d) (Tender securities)	<p>When the procuring entity requires suppliers or contractors submitting tenders to provide a tender security:</p> <p>(d) Prior to submitting a tender, a supplier or contractor may request the procuring entity to confirm the acceptability of a proposed issuer of a tender security, or of a proposed confirmer, if required; the procuring entity shall respond promptly to such a request;</p>
34 (1) (Examination, evaluation and comparison of tenders)	<p>(a) The procuring entity may ask suppliers or contractors for clarifications of their tenders in order to assist in the examination, evaluation and comparison of tenders. No change in a matter of substance in the tender, including changes in price and changes aimed at making an unresponsive tender responsive, shall be sought, offered or permitted;</p>

<i>Article</i>	<i>Content</i>
	(b) Notwithstanding subparagraph (a) of this paragraph, the procuring entity shall correct purely arithmetical errors that are discovered during the examination of tenders. The procuring entity shall give prompt notice of any such correction to the supplier or contractor that submitted the tender.
36 (1) (Acceptance of tender and entry into force of procurement contract)	Subject to articles 12 and 34 (7), the tender that has been ascertained to be the successful tender pursuant to article 34 (4)(b) shall be accepted. Notice of acceptance of the tender shall be given promptly to the supplier or contractor submitting the tender.
37 (3) (CHAPTER IV. PRINCIPAL METHOD FOR PROCUREMENT OF SERVICES, Notice of solicitation of proposals)	<p>(Subject to approval by ... (the enacting State designates an organ to issue the approval),) where direct solicitation is necessary for reasons of economy and efficiency, the procuring entity need not apply the provisions of paragraphs (1) and (2) of this article in a case where:</p> <p>(a) The services to be procured are available only from a limited number of suppliers or contractors, provided that it solicits proposals from all those suppliers or contractors; or</p> <p>(b) The time and cost required to examine and evaluate a large number of proposals would be disproportionate to the value of the services to be procured, provided that it solicits proposals from a sufficient number of suppliers or contractors to ensure effective competition; or</p> <p>(c) Direct solicitation is the only means of ensuring confidentiality or is required by reason of the national interest, provided that it solicits proposals from a sufficient number of suppliers or contractors to ensure effective competition.</p>
44 (b) to (f) (Selection procedure with consecutive negotiations)	<p>Where the procuring entity, in accordance with article 41 (1), uses the procedure provided for in this article, it shall engage in negotiations with suppliers and contractors in accordance with the following procedure:</p> <p>(b) Invite for negotiations on the price of its proposal the supplier or contractor that has attained the best rating in accordance with article 42 (1);</p> <p>(c) Inform the suppliers or contractors that attained ratings above the threshold that they may be considered for negotiation if the negotiations with the suppliers or contractors with better ratings do not result in a procurement contract;</p> <p>(d) Inform the other suppliers or contractors that they did not attain the required threshold;</p> <p>(e) If it becomes apparent to the procuring entity that the negotiations with the supplier or contractor invited pursuant to subparagraph (b) of this article will not result in a procurement contract, inform that supplier or contractor that it is terminating the negotiations;</p> <p>(f) The procuring entity shall then invite for negotiations the supplier or contractor that attained the second best rating; if the negotiations with that supplier or contractor do not result in a procurement contract, the procuring entity shall invite the other suppliers or contractors for negotiations on the</p>

<i>Article</i>	<i>Content</i>
47 (1) (Restricted tendering)	<p>basis of their ranking until it arrives at a procurement contract or rejects all remaining proposals.</p> <p>(a) When the procuring entity engages in restricted tendering on the grounds referred to in article 20 (a), it shall solicit tenders from all suppliers and contractors from whom the goods, construction or services to be procured are available;</p> <p>(b) When the procuring entity engages in restricted tendering on the grounds referred to in article 20 (b), it shall select suppliers or contractors from whom to solicit tenders in a non-discriminatory manner and it shall select a sufficient number of suppliers or contractors to ensure effective competition.</p>

10. As may be seen from the table above, most exceptions refer to situations when communications are made by a procuring entity to any single supplier or contractor participating in the procurement proceedings. Some exceptions, however, refer to more general communications addressed to all suppliers or contractors involved in the procurement proceedings.

11. In the exclusively paper-based environment, these exceptions allow faster communication of information between a procuring entity and suppliers or contractors concerned. In the electronic environment, there are means to achieve the same goal by more efficient and transparent means, such as e-mails.

12. At least with respect to information to be communicated to all suppliers or contractors participating in a particular procurement, it may be more appropriate for the Model Law to encourage the use of electronic means, rather than telephones, in-person meetings or other means of communication that do not provide a record of the content of the information communicated using such means. Although the Model Law requires that when such latter means are used, confirmation of the communication must immediately be given to the recipient in a form that provides a record of the content of the communicated information, practical difficulties may exist with verification of compliance with that requirement and its enforceability. Thus the exceptions may create conditions for abuse, including corruption and favouritism, and the Working Group may consider that they should be limited to accommodate only those situations that are strictly necessary.

13. In line with its intention to encourage where appropriate the use of electronic means of communication and to ensure more transparency in public procurement, the Working Group may wish to consider which exceptions are justifiable to retain in paragraph (2) and which could be dispensed with in the light of the widespread use of e-mails and other modern means of communication.

Paragraph (3)

14. The paragraph lists information about communications in procurement, which the procuring entity has to specify in the beginning of the procurement proceedings.

Paragraph (4)

15. The paragraph sets out standards for the means by which information is communicated, requirements for “writing” and “signature” are met and meetings are

held. Additional standards apply to the means by which meetings are held. They are based on the wording of the revisions to article 33 (2) agreed upon at the Working Group's tenth session (see paragraph 30 below).

Paragraph (5)

16. Paragraph (5) is expressed in the passive, as was suggested at the Working Group's tenth session, to cover situations when other branches of law may or should regulate the issues of authenticity, integrity and confidentiality of information communicated *inter alia* in the context of public procurement.⁴

Use of terms

17. The proposed text refers to "document, notification, decision and other information" in paragraph (1) while in subsequent paragraphs it refers to "information" alone. The Working Group may wish to consider using the full list consistently throughout the text or retaining the reference only to "information" for the sake of conciseness after the guidance as to what the article is aimed at is provided in paragraph (1). The Guide may give examples of types of information other than documents, notifications and decisions referred to in the article.

Location of the provisions

18. The Working Group may wish to defer its decision on the final location of the provisions until a later date.

2. Guide to Enactment text

19. The draft texts for the Guide that would accompany provisions of the Model Law on (i) the use of electronic means of communication in general, (ii) functional equivalence, (iii) choice of means of communication and (iv) requirement as regards form of communication were presented to the Working Group at its eighth and ninth sessions (documents A/CN.9/WG.I/WP.38 (the text following paragraphs 23), 38/Add.1 (the text following paragraph 4), 42 (the text following paragraphs 13, 19 and 26) and 42/Add.1 (the text following paragraphs 2 and 5)).

20. Following the consolidation of all the relevant provisions in one article dealing with communications in procurement, a new consolidated text for the Guide is being prepared and will be presented to the Working Group for consideration at a future session. The revised text for the Guide will incorporate relevant suggestions made at the Working Group's sessions.

21. Furthermore, also at the Working Group's eighth and ninth sessions, the Secretariat proposed the additions to the Guide text that accompany some of the existing provisions of the Model Law, such as article 36 on acceptance of tender and entry into force of procurement contract (documents A/CN.9/WG.I/WP.42 (the text following paragraph 29), and 42/Add.1 (the text following paragraph 6), revising the text in document A/CN.9/WG.I/WP.38/Add.1 following paragraph 14). They will also be amended to reflect the relevant deliberations at the Working Group's subsequent sessions.

⁴ Ibid., para. 22.

B. Electronic submission of tenders

1. Proposed draft text for the revised Model Law

22. The following draft text for article 30 (5) incorporates drafting suggestions made at the Working Group's tenth session:⁵

“Article 30. Submission of tenders

- (5) (a) A tender shall be submitted in writing, and signed, and:
 - (i) if in paper form, in a sealed envelope; or
 - (ii) if in any other form, according to requirements specified by the procuring entity, which ensure at least a similar degree of [authenticity,] [security,] integrity and confidentiality;
- (b) The procuring entity shall, on request, provide to the supplier or contractor receipt showing the date and time when its tender was received;
- (c) The procuring entity shall preserve the integrity and confidentiality of a tender from the time as determined by the procuring entity, but in no case later than the time of its receipt, and shall ensure that the content of the tender is examined only after its opening in accordance with this Law.”

Commentary

Paragraph 5 (a)(ii)

23. The Working Group may wish to consider whether references to “authenticity” and “security” of tenders should be inserted in paragraph 5 (a)(ii). In current article 30 (5)(b) of the Model Law, in the same context, the reference is made in addition to the requirement of confidentiality to the requirements of authenticity and security of tenders.

24. At the tenth session, the issue of security was discussed only in the context of paragraph 5 (c) above: it was suggested that in that context the security requirement should not appear since the requirements of integrity and confidentiality were sufficient (although some doubts were expressed about that suggestion).⁶ The Working Group may wish to consider whether the same is true in the context of paragraph 5 (a)(ii).⁷

25. As regards the issue of authenticity, the Working Group may wish to consider whether the requirement of signature in the opening phrase of paragraph 5 (a) will always ensure authenticity of tenders (for example, in situations where a supplier sends several signed tenders from different addresses, which would raise the issue of authenticity in determining which tender is final and binding on the supplier).

⁵ Ibid., paras. 27-28.

⁶ Ibid., para. 29.

⁷ At the tenth session, in the context of paragraph 5 (a) (ii), it was suggested to replace the word “protection” with “integrity and confidentiality”. No issues of security and authenticity of tenders were raised. A/CN.9/615, para. 28 (iii).

Paragraph 5 (b)

26. The paragraph reproduces provisions of article 30 (5)(c) of the Model Law without change.

Paragraph 5 (c)

27. The paragraph is new and based on the draft provisions agreed upon at the Working Group's tenth session.⁸

2. Guide to Enactment text

28. At the Working Group's tenth session, the point was made that the Guide should provide guidance to enacting States as regards separate treatment of submission and receipt of tenders in the paper and electronic environments to avoid overly stringent requirements in traditional tendering, and the need to avoid imposing excessive requirements on the electronic submission of tenders (which might otherwise discourage such submissions).⁹

29. The draft text for the Guide that would accompany a revised article 30 (5) was presented to the Working Group, at its eighth session, in document A/CN.9/WG.I/WP.38/Add.1, the text following paragraph 26. Since then, a number of suggestions have been made to the text. The revised text for the Guide that will replace in entirety the previously proposed text is being prepared and will be presented to the Working Group for consideration at a future session.

C. Presence at the opening of tenders

30. At its tenth session, the Working Group decided to base its future consideration of provisions for revised article 33 (2) on the following text:¹⁰

“Article 33. Opening of tenders

(2) All suppliers or contractors that have submitted tenders, or their representatives, shall be permitted by the procuring entity to be present at the opening of tenders. Suppliers or contractors shall be deemed to have been permitted to be present at the opening of the tenders if they are fully apprised of the opening of the tenders contemporaneously through the means of communication used by the procuring entity.”

31. A revised text of draft article 5 bis above incorporates the requirement for holding meetings, which will also apply to opening of tenders (see article 5 bis (4) in paragraph 4 above). For avoidance of a repetition, the Working Group may wish to shorten the second sentence of the text in the preceding paragraph to read:

“Suppliers or contractors shall be deemed to have been permitted to be present at the opening of the tenders if conditions of article [5 bis (3)(d) and (4)] are met.”

32. The draft text for the Guide that would accompany a revised article 33 (2) will be prepared and presented to the Working Group for consideration at a future

⁸ A/CN.9/615, para. 28.

⁹ Ibid., para. 30.

¹⁰ Ibid., para. 32.

session, reflecting suggestions made at the Working Group's session for reflection in such a text.

D. Publication of procurement-related information

1. Proposed revisions to article 5

33. At its tenth session, the Working Group agreed to split the current text of article 5 of the Model Law into two paragraphs: the first paragraph dealing with legal texts (law, procurement regulations and directives of general application) that had to be made accessible to the public, with respect to which the requirements to "systematically maintain" would remain; and the second paragraph dealing with judicial decisions and administrative rulings of precedent value and general application, with respect to which the requirement to "systematically maintain" would be replaced with the requirement "to update on a regular basis if need be".¹¹ The Working Group may therefore wish to consider the following text:

"Article 5. Publicity of legal texts

(1) The text of this Law, procurement regulations and all directives of general application in connection with procurement covered by this Law, and all amendments thereto, shall be promptly made accessible to the public and systematically maintained.

(2) Judicial decisions and administrative rulings with precedent value and of general application in connection with procurement covered by this Law, and all amendments thereto, shall be made available to the public and updated on a regular basis if need be."

Commentary

34. The amendments to the article reflect the deliberations on article 5 at the Working Group's ninth and tenth sessions, such as concerns that the requirements found in the current article 5 of the Model Law as regards the public accessibility of legal texts and their systematic maintenance appeared to be too onerous with respect to some types of legal texts. The suggestions were made to reconsider the application of these requirements to such legal texts as judicial decisions and administrative rulings.¹²

35. In the light of the changes made to the article (in particular paragraph (2) that refers to public availability, not public accessibility, of the texts referred therein), it is suggested that the title of the article should be changed from "Public accessibility of legal texts" to "Publicity of legal texts".

36. The draft text for the Guide that would accompany a revised article 5 was submitted to the Working Group for consideration at its ninth session in document A/CN.9/WG.I/WP.42, the text following paragraph 45 (a). This text will be revised to reflect the Working Group's discussion of the relevant issues.

¹¹ Ibid., para. 33. See also A/CN.9/WG.I/WP.47, para. 31.

¹² A/CN.9/595, paras. 68-72, and A/CN.9/615, para. 33.

2. Proposed draft text for the revised Model Law addressing the publication of information on forthcoming procurement opportunities

37. At its tenth session, the Working Group agreed that enabling provisions on publication of information on forthcoming procurement opportunities should be included in the Model Law, based on the wording of the text contained in paragraph 33 of document A/CN.9/WG.I/WP.47.¹³ The Working Group may therefore wish to consider the following text:

“As [promptly] as possible after beginning of a fiscal year procuring entities may publish information of the expected procurement opportunities for the following [the enacting State specifies the period], and this information shall not constitute the solicitation of the participation of suppliers or contractors in the procurement proceedings.”

Commentary

38. The Working Group may wish to consider that the wording “as promptly as possible” in the text above should be changed to a less prescriptive wording, such as “as early as possible”, in the light of the permissive nature of the provisions.

39. The ending of the provisions that reads “the solicitation of the participation of suppliers or contractors in the procurement proceedings” has replaced the previous reference to “the solicitation documents or parts thereof”. The suggested new wording is broader and covers all procurement methods under the Model Law (the reference to solicitation documents in the Model Law is relevant only in the context of tendering proceedings). This broader reference is used for example in articles 8 (3) and 9 (1) of the Model Law as well as in the revised article 5 bis (3) above.

40. The Working Group is still to decide about the location of these provisions in the Model Law. At a Working Group’s previous session, the suggestion was made to include provisions on publication of information on forthcoming procurement opportunities in article 5.¹⁴ However, taking into account that the current article 5 deals with publication of regulatory legal texts, the appearance of the provisions on publication of information on forthcoming procurement opportunities in that article may give the wrong impression about the intended nature of that information (informative as opposed to regulatory and binding). It may be more appropriate to include provisions on publication of information on forthcoming procurement opportunities in a separate article.

41. The Working Group may wish to defer its decision on the location of the provisions to a later date, in the light of its decisions on the location of other articles, such as article 5 bis that would set rules for communications in procurement, which may also apply to the publication of information on forthcoming procurement opportunities.

42. The draft text for the Guide that would accompany provisions on publication of information on forthcoming procurement opportunities was submitted to the Working Group for consideration at its ninth session in document A/CN.9/WG.I/WP.42, the text following paragraph 45 (b). This text will be revised to reflect the Working Group’s discussion of the relevant issues.

¹³ A/CN.9/615, para. 36.

¹⁴ A/CN.9/595, para. 76.

III. Draft provisions addressing abnormally low tenders

1. Proposed draft text for the revised Model Law

43. At its tenth session, the Working Group requested the Secretariat to propose the appropriate location for the provisions on ALTs, taking into account that risks of ALTs should be addressed by the procuring entity not only in the context of examination, evaluation and comparison of tenders in the tendering proceedings, as was originally implied by placing provisions in article 34 of the Model Law, but in addition at any other stage of the procurement, including during qualification of suppliers, and in procurement proceedings by means other than tendering.¹⁵

44. At the same session, the drafting suggestions were made to the text of the provisions on ALTs that were before the Working Group in document A/CN.9/WG.I/WP.43/Add.1 (the text following paragraph 8).¹⁶

45. The text below incorporates those suggestions and is presented as a new article 12 bis. In the process of revising the structure of the Model Law, the Working Group may wish to consider putting all articles addressing rejection of tenders, such as articles 12, 15 and the proposed article 12 bis, in one cluster, one after another.

“Article [12 bis]. Rejection of abnormally low tenders, proposals, offers, quotations or bids

(1) The procuring entity may reject a tender, proposal, offer, quotation or bid if a price submitted therein is abnormally low in relation to the goods, construction or services to be procured, provided that:

(a) The procuring entity has requested in writing details of constituent elements of a tender, proposal, offer, quotation or bid that give rise to concerns as to the ability of the supplier or contractor that submitted such a tender, proposal, offer, quotation or bid to perform the procurement contract;

(b) The procuring entity has taken account of the information supplied, if any, but continues, on a reasonable basis, to hold those concerns; and

(c) The procuring entity has recorded those concerns and its reasons for holding them, and all communications with the supplier or contractor under this article, in the record of the procurement proceedings.

(2) The decision of the procuring entity to reject a tender, proposal, offer, quotation or bid in accordance with this article and grounds for the decision shall be recorded in the record of the procurement proceedings and promptly communicated to the supplier or contractor concerned.”

Commentary

46. The provisions contain a reference to “bid” along references to “tenders, proposals, offers and quotations”. This is in the light of the draft provisions on electronic reverse auctions submitted to the Working Group for consideration at its eleventh session in document A/CN.9/WG.I/WP.51. Additional references may be

¹⁵ A/CN.9/615, para. 75.

¹⁶ Ibid., para. 73.

needed in the light of the provisions on framework agreements (see document A/CN.9/WG.I/WP.52).

47. The Working Group deferred its decision on whether any action regarding ALTs by the procuring entity should be open to review. The Working Group noted that domestic regulation of that issue might vary significantly. It was suggested that the Working Group might revert to that point when it considered review provisions.¹⁷

2. Proposed draft text for the revised Guide

48. At its tenth session, the Working Group considered the text of the Guide that would accompany provisions of the Model Law on ALTs. A number of drafting suggestions were made to that text.¹⁸

49. The revised text below reflects those suggestions. It replaces in entirety the previously proposed texts in documents A/CN.9/WG.I/WP.43/Add.1 (the text following paragraphs 13) and 40/Add.1 (the texts following paragraphs 27 and 28).

“Article [12 bis]. Rejection of abnormally low tenders, proposals, offers, quotations or bids

(1) The purpose of the article is to enable, but not to require, the procuring entity to reject abnormally low tenders, proposals, offers, quotations or bids (henceforth referred to as “abnormally low tenders”) that give rise to procuring entity’s concerns as to the ability of the supplier or contractor that submitted such an abnormally low tender to perform the procurement contract.

(2) The article does not require any approval of a higher administrative authority for the procuring entity to take measures referred to in the article. The article applies to any procurement proceedings under the Model Law, including one involving an electronic reverse auction, where risks of abnormally low tenders may be especially high.

(3) The article provides necessary safeguards that aim to protect legitimate interests of both sides: procuring entities and suppliers and contractors. On the one hand, it enables the procuring entity to address possible abnormally low tenders before a procurement contract has been concluded. From the perspective of the procuring entity, an abnormally low tender involves a risk that the contract cannot be performed, or performed at the price tendered, and additional costs and delays to the project may ensue leading to higher prices and disruption to the procurement concerned. The procuring entity should therefore take steps to avoid running such a performance risk.

(4) On the other hand, the article protects suppliers and contractors against the possibility of arbitrary decisions and abusive practices by procuring entities. The procuring entity cannot automatically reject a tender simply on the basis that the tender price appears to be abnormally low. Conferring such a right on procuring entities would introduce the possibility of abuse as tenders could be rejected for being abnormally low without justification, or on the basis of a purely subjective criterion. Such a risk is especially acute in international procurement, where an abnormally low price in one country

¹⁷ Ibid., para. 74.

¹⁸ Ibid., paras. 76-78.

might be perfectly normal in another. In addition, some prices may seem to be abnormally low if they are below cost; however, selling old stock below cost, or engaging in below cost pricing to keep a workforce occupied, subject to applicable competition regulations, might be legitimate.

(5) For these reasons, the Model Law allows the rejection of an abnormally low tender only when the procuring entity has concerns as to the ability of the supplier or contractor to perform the procurement contract. This, however, is without prejudice to any other applicable law that may require the procuring entity to reject the abnormally low tender, for example, if criminal acts (such as money-laundering) or illegal practices (such as non-compliance with minimum wage or social security obligations) are involved. In any case, proper procedures should be in place to ensure due process and prevent arbitrary decisions and abusive practices.

(6) Subparagraphs 1 (a) to (c) of the article specify the steps that the procuring entity has to take before the abnormally low tender may be rejected, to ensure due process is followed and the rights of the supplier or contractor concerned are preserved.

(7) First, a written request for clarification must be made to the supplier or contractor concerned about details of constituent elements of the submitted tender, which the procuring entity considers relevant for justification of the price submitted. Those details may include: the methods and economics of the manufacturing process for the goods or of the construction methods or of the services provided; the technical solutions chosen and/or any exceptionally favourable conditions available to the supplier or contractor for the execution of the construction or for the supply of the goods or services; or the originality of the construction, supplies or services proposed by the supplier or contractor.

(8) The enacting State may choose to regulate which type of information the procuring entity may request to submit for price justification. It should be noted in this context that the assessment is whether the price is “realistic” (that is, the price reflects market conditions and not a loss-leading or other pricing strategy with steep discounts to gain a competitive advantage), using such factors as pre-tender estimates, market prices or prices of previous contracts, where available. It might not be appropriate to request information about the underlying costs that will have been used by suppliers and contractors to determine the price itself. Since cost assessment can be cumbersome and complicated, and is also not possible in all cases, the ability of the procuring entities to assess prices on the basis of cost may be limited. In some jurisdictions, procuring entities may be barred by law from demanding information relating to cost structure, because of risks that such information could be misused.

(9) The procuring entity should take account of the response supplied by the supplier or contractor in the price assessment. The supplier’s refusal to provide information requested by the procuring entity should not give an automatic right to the procuring entity to reject the abnormally low tender. The price assessment must be carried out in any case and on a purely objective basis. It may turn out during such assessment that the abnormally low tender was submitted due to a misunderstanding or other error.

(10) If after price justification the procuring entity continues to hold concerns about the ability of the supplier or contractor to perform the procurement

contract, it must record those concerns and its reasons for holding them in the record of procurement proceedings pursuant to subparagraph (1) (c) of the article. This provision is included to ensure that before a decision to reject the abnormally low tender is made, all information relevant to that decision is properly recorded for the sake of accountability, transparency and objectivity in the process.

(11) Only after the steps outlined in subparagraphs 1 (a) to (c) have been fulfilled, may the procuring entity reject the abnormally low tender. The decision on the rejection of the abnormally low tender must be included in the record of the procurement proceedings and promptly communicated to the supplier or contractor concerned, under paragraph (2) of the article. [If the Working Group decides that an appeal against the rejection should be allowed, reference and comment would appear here]

(12) Enacting States should be aware that, apart from the measures envisaged in this article, other measures can effectively prevent the performance risks resulting from abnormally low tenders. Thoroughly evaluating suppliers' qualifications, tenders, proposals, offers, quotations or bids can play an especially important role in this context, which in turn depends on the proper formulation of qualification requirements and the precise drafting of specifications. Procuring entities should be appropriately instructed to that end, and should be aware of the needs to compile accurate and comprehensive information about the qualifications of suppliers or contractors, including information about their past performance, and to pay due attention in evaluation to all aspects of submitted tenders, proposals, offers, quotations or bids, not only to price (such as to maintenance and replacement costs where appropriate).

(13) Additional measures may include: (i) promotion of awareness of the adverse effects of abnormally low tenders; (ii) provision of training, adequate resources and information to procurement officers, including reference or market prices; and (iii) allowing for sufficient time for each stage of the procurement process. The solicitation documents or other documents for solicitation of proposals, offers, quotations or bids may include an explicit statement to the effect that the procuring entity is not obligated to accept any tender, and that a procuring entity may carry out analyses of potential performance risk and prices submitted."

**F. Note by the Secretariat on revisions to the UNCITRAL Model Law on
Procurement of Goods, Construction and Services — drafting materials for
the use of electronic reverse auctions in public procurement, submitted to the
Working Group on Procurement at its eleventh session
(A/CN.9/WG.I/WP.51) [Original: English]**

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I. Introduction

1. The background to the current work of Working Group I (Procurement) on the revision of the UNCITRAL Model Law on Procurement of Goods, Construction and Services (the “Model Law”) (A/49/17 and Corr.1, annex I) is set out in paragraphs 5 to 65 of document A/CN.9/WG.I/WP.49, which is before the Working Group at its eleventh session. The main task of the Working Group is to update and revise the Model Law, so as to take account of recent developments, including the use of electronic reverse auctions (“ERAs”), in public procurement.

2. Such use was included in the topics before the Working Group at its sixth to tenth sessions. At its tenth session, the Working Group requested the Secretariat to revise the relevant drafting materials that it had considered at the session.¹ This note has been prepared pursuant to that request, and sets out the drafting materials on ERAs, revised to take account of the Working Group’s deliberations at its tenth session.²

II. Draft provisions to enable the use of electronic reverse auctions in public procurement under the Model Law

A. Location of draft provisions

3. At its tenth session, the Working Group agreed on a preliminary basis to include provisions stipulating the conditions for the use of ERAs in chapter II of the Model Law (which listed methods of procurement and their conditions for use). Provisions on procedural matters of ERAs, it was agreed, would be included elsewhere, such as in chapter V of the Model Law (which described procedures for alternative methods of procurement). This location, it was observed, would permit ERAs to be employed not only on a stand-alone basis, but also in conjunction with various procurement methods, such as tendering or request for quotations, and procurement techniques that may be envisaged by the revised Model Law, such as framework agreements.³

4. If the Working Group decides to keep the provisions relating to ERAs in the locations agreed to on a preliminary basis at the tenth session, the Working Group may wish to consider splitting each of the two relevant chapters into sections: the first section would deal with procurement methods while the other would deal with procurement mechanisms, such as ERAs. Consequentially, the titles of the amended chapters should include not only a reference to procurement methods but also to procurement mechanisms (the Working Group may wish to consider in due course which generic term it should apply to procurement mechanisms, such as ERAs, framework agreements, suppliers’ lists and dynamic purchasing systems, which are not procurement methods).

5. Following this approach, draft provisions on conditions for the use of ERAs are presented in article 22 bis, proposed to be included in section II of an expanded chapter II. Draft provisions on procedural aspects of ERAs are presented in draft

¹ A/CN.9/615, para. 11.

² Ibid., paras. 37 to 71.

³ Ibid., paras. 37-38, 50, 59 and 64.

articles 51 bis to 51 septies,⁴ proposed to be included in a section of an expanded chapter V.

B. Conditions for the use of electronic reverse auctions: draft article 22 bis

1. Proposed draft text for the revised Model Law

6. The draft article 22 bis below draws on the text of a draft article on conditions for the use of electronic reverse auctions that was before the Working Group at its tenth session, and reflects amendments suggested to be made thereto:⁵

“Article 22 bis. Conditions for use of electronic reverse auctions

“A procuring entity may engage in procurement by means of an electronic reverse auction in accordance with articles [51 bis to 51 septies] in the following circumstances:

[(a) Where it is feasible for the procuring entity to formulate detailed and precise specifications for the goods [or construction or, in the case of services, to identify their detailed and precise characteristics]];

(b) Where there is a competitive market of suppliers or contractors anticipated to be qualified to participate in the electronic reverse auction such that effective competition is ensured;

(c) Where the procurement concerns goods[, construction or services] that are generally available on the market[, provided that the construction or services are of a simple nature]; and

(d) Where the price is the only criterion to be used in determining the successful bid. [The procurement regulations may establish conditions for the use of electronic reverse auctions in procurement where other criteria [that can be expressed in monetary terms and can be evaluated automatically through the auction] may be used in determining the successful bid.]”

Commentary

7. Subparagraph (a) is placed in square brackets, to reflect (as noted at the Working Group’s tenth session) that text may be superfluous in the light of subparagraph (c) (compliance with the conditions of the latter, it was said, necessarily involved compliance with the requirements of subparagraph (a)).⁶ Other changes have been made to that paragraph to align it with the wording of similar provisions of the Model Law.⁷

⁴ Although the Working Group, at its tenth session, anticipated that the provisions relating to procedural aspects of ERAs, which were presented at that session in two articles (47 bis and 47 ter), would be merged in one composite article, it was not feasible to comply with that request due to the length of the provisions and distinct matters and stages of ERA that they address. *Ibid.*, paras. 48, 57 and 63.

⁵ *Ibid.*, paras. 41, 45, 51 and 52.

⁶ *Ibid.*, para. 42.

⁷ See, for example, articles 19 (1)(a) and 38 (g) of the Model Law, where the reference is made to characteristics rather than specifications, of services.

8. The references to “construction or services” throughout the text above, and the provision in subparagraph (c) linked to it, were put in square brackets as was agreed at the Working Group’s tenth session.⁸ The understanding is that the square brackets will remain in the final text and the Guide will explain that an enacting State may decide to delete the words contained in the square brackets and thus restrict the use of ERAs to procurement of goods alone.

9. With reference to the square brackets in subparagraph (d), the Working Group’s attention is drawn to the lack of common understanding in the Working Group at its tenth session as regards whether ERAs are to be used in procurement where all criteria for determining a successful bid can be expressed in monetary terms and automatically evaluated through the auction,⁹ or also in a more complex procurement, where not all award criteria are evaluated automatically through the auction. The Working Group considered allowing any type of ERAs in the long term, so long as transparency and objectivity in the process are preserved.¹⁰

10. Subparagraph (d), as drafted above, allows an enacting State: (i) to restrict the use of ERAs to procurement where price is the only award criterion; or (ii) to allow the use of ERAs in procurement where other award criteria may be used, provided that all award criteria can be quantified and automatically evaluated through the auction; or (iii) to allow ERAs in procurement where pre-auction evaluation of non-quantifiable criteria may take place. In the latter case, the results of such an evaluation are to be factored in the auction through a mathematical formula that allows automatic re-ranking of bidders on the basis of the results of the pre-auction evaluation and values presented through the auction.

11. All these options would be available to an enacting State if both pairs of square brackets remain in the final text. The Guide would provide guidance to the enacting State on each option, in particular pointing out: (i) that under the provisions ERAs are mainly intended for the use procurement where price is the only award criterion; (ii) benefits and risks arising from each option; and (iii) that the choice will depend on the experience with ERAs in any particular jurisdiction. Alternatively, particularly considering the longer-term view, some options could be excluded from the Model Law text at this stage, but discussed in the Guide as possible future additions where appropriate in the light of experience gained in the operation of ERAs.

12. Other provisions on ERAs in this note were drafted with a view of accommodating the use of ERAs in all three situations described in paragraph 10 above.

2. Proposed draft text for the revised Guide

13. At its tenth session, the Working Group made a number of suggestions for revision of the Guide text that would accompany the Model Law provisions on the conditions for the use of ERAs.¹¹ The revised text for the Guide that will reflect those suggestions as well as the suggestions made at the Working Group’s eighth and ninth sessions¹² will be prepared and presented to the Working Group at a

⁸ A/CN.9/615, para. 41 (i).

⁹ Ibid., paras. 44, 45, 51 and 55.

¹⁰ Ibid., para. 55.

¹¹ Ibid., paras. 46 and 47.

¹² For ease of reference, most of them have been listed in paragraphs 11 to 16 of document A/CN.9/WG.I/WP.48 that was before the Working Group at its tenth session.

future session, taking account of discussions of the draft article above. The new text intends to replace in entirety the texts in documents A/CN.9/WG.I/WP.40 (the text following paragraph 17) and 43 (the text following paragraph 35) that were before the Working Group at its eighth and ninth sessions, respectively.

C. Procedures in the pre-auction and auction stages: draft articles 51 bis to septies

1. Proposed draft texts for the revised Model Law

14. The following draft articles 51 bis to septies reflect, with some exceptions identified below, amendments suggested to be made to draft provisions on procedural aspects of ERAs at the Working Group's tenth session.¹³

“Article 51 bis. General provisions

An electronic reverse auction may be used as a stand-alone electronic reverse auction or in procurement by means of restricted tendering, competitive negotiation and request for quotations proceedings [or on reopening competition under a framework agreement and dynamic purchasing systems], when the procuring entity decides that the award of the procurement contract shall be preceded by an electronic reverse auction, provided that the conditions for the use of an electronic reverse auction stipulated in article 22 bis are met.”

Commentary to draft article 51 bis above

15. In the draft article, references are made to procurement methods where it may be appropriate, in the light of the conditions for the use of ERAs set out in draft article 22 bis above, and of the existing provisions of the Model Law, to use ERAs as an optional phase preceding the award of the procurement contract.

16. For instance, the requirements in draft article 22 bis (a) and (c) prevent the use of ERAs in two-stage tendering, request for proposals and the principal method for procurement of services. According to the Model Law provisions on conditions for use of those procurement methods and on their procedures, each of these procurement methods is mainly intended for use in procurement of complex goods, construction or services.¹⁴ Single-source procurement is naturally excluded from the scope of draft article 51 bis.

17. In other procurement methods, such as restricted tendering, competitive negotiation and request for quotations, the use of ERAs may be envisaged, provided that the conditions for their use set out in draft article 22 bis are met. In addition, the use of ERAs may be appropriate in framework agreements and dynamic purchasing systems upon (re)opening competition, as for example envisaged in European Union Directive 2004/18/EC, article 54 (2). Inclusion of references to these procurement mechanisms in draft article 51 bis above is indicative and without prejudice to the Working Group's deliberations on these procurement mechanisms (see A/CN.9/WG.I/WP.52 and Add.1).

¹³ A/CN.9/615, paras. 48-63 and 67.

¹⁴ See article 18 (3) and chapter IV of the Model Law as relevant to the principal method for procurement of services; and articles 19 (1), 46 and 48 of the Model Law as relevant to two-stage tendering and request for proposals.

18. No reference in draft article above is made to chapter III (Tendering proceedings). This is because one of the variations of stand-alone ERAs under draft article 51 ter below would constitute the use of ERAs in chapter III tendering proceedings.

“Article 51 ter. Pre-auction procedures in stand-alone electronic reverse auctions

(1) The procuring entity shall cause a notice of the electronic reverse auction to be published in ... (each enacting State specifies the official gazette or other official publication in which the notice is to be published).

(2) The notice shall include, at a minimum, the following:

(a) Information referred to in article 25 (1)(a), (d) and (e), and article 27 (d), (f), (h) to (j) and (t) to (y);

(b)

Alternative A

[The statement that price is the only criterion to be used by the procuring entity in determining the successful bid;]

Alternative B

[The criteria to be used by the procuring entity in determining the successful bid, provided that such criteria can be expressed in monetary terms and can be evaluated automatically through the electronic reverse auction, and, where applicable, any mathematical formula to be used in the auction that will automatically rank and re-rank suppliers or contractors participating in the auction (the “bidders”) on the basis of the values submitted through the auction;]

Alternative C

[The criteria to be used by the procuring entity in determining the successful bid and, where applicable, any mathematical formula to be used in the auction that will automatically rank and re-rank suppliers or contractors participating in the auction (the “bidders”) on the basis of the results of the pre-auction evaluation, if any, and values submitted through the auction. If not all award criteria are subject of automatic evaluation through the electronic reverse auction, in addition information about:

(i) Features, the values for which are subject of evaluation through the electronic reverse auction, provided that such features can be expressed in monetary terms and can be evaluated automatically through the auction; and

(ii) Features, the values for which are subject of evaluation before the auction and the relative weight assigned to such features in the evaluation procedure;]

(c) Whether any limitation on the number of suppliers or contractors to be invited to the auction is imposed, and if so, such number and the criteria and procedure that will be followed in selecting that number of suppliers or contractors;

- (d) Whether prequalification is required and, if so, information referred to in article 25 (2)(a) to (e);
 - (e) Whether submission of initial bids is required and, if so:
 - (i) information referred to in articles 25 (f) to (j);
 - (ii) whether initial bids are to be submitted for assessment of their responsiveness to the requirements specified in the notice of the auction or in addition for their full or partial evaluation; and
 - (iii) if evaluation is involved, procedures and criteria to be used in such evaluation;
 - (f) The [website or other electronic] address at which the electronic reverse auction will be held, and information about the electronic equipment being used and technical specifications for connection;
 - (g) The manner and, if already known, deadline by which the suppliers and contractors shall register to participate in the auction;
 - (h) If already known, the date and time of the opening and criteria governing the closing of the auction;
 - (i) If already known, whether there will be only a single stage of the auction, or multiple stages (in which case, the number of stages and the duration of each stage);
 - (j) The rules for the conduct of the electronic reverse auction;
 - (k) Unless set out in the rules for the conduct of the electronic reverse auction, the information that will be made available to the bidders in the course of the auction and, where appropriate, how and when it will be made available; and
 - (l) Unless set out in the rules for the conduct of the electronic reverse auction, the conditions under which the bidders will be able to bid and, in particular, any minimum differences in price or other features that must be improved in any new submission during the auction.
- (3) Except as provided for in paragraphs (4) to (6) of this article, the notice of the electronic reverse auction shall serve as an invitation to participate in the auction and shall be complete in all respects, including as regards information specified in paragraph (7) of this article.
- (4) Where a limitation on the number of suppliers or contractors to be invited to the auction is imposed, the procuring entity shall:
- (a) Select suppliers or contractors corresponding to the number and in accordance with the criteria and procedure specified in the notice of the electronic reverse auction; and
 - (b) Send an invitation to prequalify or to submit initial bids or to participate in the auction, as the case may be, individually and simultaneously to each selected supplier or contractor.
- (5) Where prequalification is required, the procuring entity shall:
- (a) Prequalify suppliers or contractors in accordance with article 7; and

(b) Send an invitation to submit initial bids or to participate in the auction, as the case may be, individually and simultaneously to each prequalified supplier or contractor.

(6) Where submission of the initial bids is required, the procuring entity shall:

(a) Include in the solicitation documents information referred to in article 27 (a), (k) to (s) and (z) of this Law;

(b) Solicit and examine initial bids in accordance with articles 26, 28 to 32, 33 (1) and 34 (1) of this Law;

(c) As specified in the notice of the electronic reverse auction, assess responsiveness of initial bids to all requirements set out in the notice of the electronic reverse auction in accordance with article 34 (2) or in addition carry out full or partial evaluation of initial bids in accordance with the procedures and criteria set out in the notice of the electronic reverse auction; and

(d) Send an invitation to participate in the auction individually and simultaneously to each supplier or contractor except for those whose bid has been rejected in accordance with article 34 (3). Where evaluation of initial bids took place, the invitation shall be accompanied by the information on the outcome of such evaluation, including any ranking assigned to each supplier or contractor concerned.

(7) Unless already provided in the notice of the electronic reverse auction, the invitation to participate in the auction shall set out:

(a) The manner and deadline by which the invited suppliers and contractors shall register to participate in the auction;

(b) The date and time of the opening and criteria governing the closing of the auction;

(c) The requirements for registration and identification of bidders at the opening of the auction;

(d) Information concerning individual connection to the electronic equipment being used; and

(e) All other information concerning the electronic reverse auction necessary to enable the supplier or contractor to participate in the auction.

(8) The fact of the registration to participate in the auction shall be promptly confirmed individually to each registered supplier or contractor.

(9) The auction shall not take place before expiry of [two] working days after the notice of the electronic reverse auction has been issued or, where invitations to participate in the auction are sent, from the date of sending the invitations to all suppliers or contractors concerned.”

Commentary to draft article 51 ter above*General comments*

19. The text above has been drafted to allow the use of stand-alone ERAs in different situations envisaged in draft article 22 bis (d) above.

20. Some provisions are tailored for simple ERAs, where only price or in addition other quantifiable features are used as award criteria to be evaluated automatically through the auction. Other provisions are tailored for more complex ERAs where some award criteria are to be evaluated before the auction.

21. The draft article envisages that the procuring entity may request the submission of initial bids. In simple ERAs, this may be necessary to assess responsiveness of bids to the requirements set out in the notice of the ERA. In more complex ERAs, this will be necessary for pre-auction evaluation, full or partial, during which initial bids are not only checked against the requirements set out in the notice of ERA but they are also compared with each other.

22. In both simple and complex ERAs, pre-selection and/or prequalification may be involved. When no pre-selection is involved, the procuring entity invites all suppliers or contractors who expressed interest to participate in the auction directly to the ERA or to prequalify or to submit initial bids, as the case may be.

23. When a large number of suppliers or contractors is anticipated to express interest to participate in the ERA, the procuring entity may for justified reasons, such as limited system capacity, restrict the number of suppliers or contractors who will be invited to proceed to the next stage of the ERA. The draft article requires that the procuring entity should specify in the notice any restrictions on the number, the number of suppliers or contractors to be pre-selected and any pre-selection criteria and procedure (such as first fifty who expressed interest).

24. The draft article allows but does not require prequalification. As is the practice in some jurisdictions, the procuring entity may choose to hold post-auction evaluation of qualifications of only the supplier or contractor who submits the successful bid.

Paragraph (1)

25. The Working Group may wish to decide whether the suggested wording should be replaced by the wording of, or a cross-reference to, article 24, which requires wider publicity of a solicitation notice.

Paragraph (2)

26. The cross-references in subparagraph 2 (a) are to those provisions of articles 25 and 27 that refer to information that will have to be included in the notice on the ERA regardless of whether pre-selection, prequalification or submission of initial bids is required. Specific information to be included in the notice on the ERA where pre-selection, prequalification or the submission of initial bids is required is set out in subparagraphs (c) to (e) above, respectively.

27. The alternatives in subparagraph (b) reflect changes made to the conditions for the use of ERAs in draft article 22 bis, subparagraph (d), above. Alternative A covers situations where the successful bid is determined exclusively on the basis of the price. Alternative B covers situations where price and other criteria that can be expressed in monetary terms and automatically evaluated through the auction, such

as delivery time, can be used in determining the successful bid. Alternative C covers the broadest situations where any criteria can be used in determining the successful bid.

28. The Working Group may wish to consider defining in subparagraph (b) suppliers or contractors participating in the auction as “bidders”, and use this term consistently in subsequent provisions according to the context, as was done above.

29. Subparagraphs (f) to (l) are based on the relevant provisions that were before the Working Group at its tenth session and reflect drafting suggestions proposed to those provisions at that session.¹⁵ The Working Group deferred its decision on whether in subparagraph (f) the reference should be to the address or to the website or other electronic address.¹⁶

30. Subparagraphs (g) to (i) include the qualifier phrase “if already known”. These words were included to indicate that some type of information may not be known at the time of a notice of the ERA, especially if prequalification or assessment or evaluation of initial bids is involved.

Paragraph (3)

31. The paragraph is new. It intends to cover situations where no pre-selection, prequalification or pre-auction assessment or evaluation of initial bids is involved. In such case, a notice of the ERA has to serve as an invitation to participate in the auction and therefore has to be complete in all relevant respects to enable suppliers or contractors to participate in the auction.

Paragraph (4)

Paragraph (4) is also new and was included to address pre-selection procedures. It supplements paragraph 2 (c).

Paragraphs (5), (6) and (7)

32. The paragraphs are based on the relevant provisions that were before the Working Group at its tenth session.¹⁷

Paragraphs (8) and (9)

33. The paragraphs are new. Paragraph (8) provides suppliers or contractors with the means to learn that they would indeed be considered as registered and therefore have access right to the system at the time the auction opens.

34. Paragraph (9) intends to ensure that: (i) when invitations to participate in the auction are sent, interested suppliers will have sufficient time to receive such invitation, subsequently properly to connect themselves to the system, to comply with other technical requirements to participate in the auction and to report any problems to the procuring entity; and (ii) when the notice of the ERA serves as invitation to participate in the ERA, interested suppliers will have sufficient time not only to comply with connection and other technical requirements to participate in the auction but also to prepare and submit responsive bids during the auction. The two-day requirement is taken from the European Union Directive 2004/18/EC,

¹⁵ A/CN.9/615, para. 67 under (ii), (iii) and (v).

¹⁶ Ibid., para. 67 (ii).

¹⁷ Ibid., the text of article 47 bis following para. 53, paras. 3 to 6.

article 54 (4), second paragraph. The Working Group may wish to decide that instead of fixing any time frame in numbers, the provision should contain the requirement of “[adequate/reasonable] time which is sufficiently long to allow suppliers or contractors to prepare for the auction.” This would be consistent with the approach taken, for example, in article 30 of the Model Law where the reference is made to “reasonable time”, and would be sufficiently flexible to accommodate different situations in practice.

“Article 51 quater. Pre-auction procedures in procurement by means of restricted tendering, competitive negotiation or request for quotations

(1) When the procuring entity decides that the award of the procurement contract in procurement by means of restricted tendering, competitive negotiation or request for quotations shall be preceded by an electronic reverse auction, the procuring entity when first soliciting the participation of suppliers or contractors in the procurement proceedings shall state that fact and provide information referred to in article 51 ter (2)(b) and (f) to (l).

(2) The provisions of this Law applicable to the relevant procurement proceedings shall regulate procedures preceding the electronic reverse auction in the procurement proceedings concerned.

(3) The procuring entity shall send an invitation to participate in the auction individually and simultaneously to each supplier or contractor admitted to participate in the auction.

(4) Unless already provided when first soliciting the participation of suppliers or contractors in the procurement proceedings, the invitation to participate in the auction shall set out all information referred to in article 51 ter (7).

(5) The fact of the registration to participate in the auction shall be promptly confirmed individually to each registered supplier or contractor.

(6) The auction shall not take place before expiry of [two] working days after invitations to participate in the auction have been sent to all suppliers or contractors admitted to participate in the auction.”

Commentary to article 51 quater above

35. Since ERA under draft article 51 quater is an optional phase in the referred procurement methods, all stages up to the auction itself, including solicitation mechanisms, submission of tenders, offers or quotations, their evaluation, if any, and admission of suppliers or contractors to the auction, will be regulated by the applicable provisions of the Model Law. Paragraph (2) contains cross-references to those provisions of the Model Law.

36. Provisions in paragraphs (1) and (3) to (6) intend to accommodate the use of ERAs in those procurement proceedings. Paragraph (1) requires disclosing at the beginning of the procurement proceedings the fact that ERA will be held and other information relevant to ERA, which is the same as listed in article 51 ter (2)(b) and (f) to (l). To avoid repetitive listing, an appropriate cross-reference to draft article 51 ter has been inserted. Provisions of paragraphs (4) to (6) above correspond in the relevant parts to the provisions of paragraphs (7) to (9) of draft article 51 ter.

37. No provisions have been drafted on the use of ERAs in framework agreements or other procurement mechanisms, pending the Working Group's consideration of the relevant topics.

“Article 51 quinquies. Requirement of effective competition

(1) The procuring entity shall ensure that the number of suppliers or contractors invited to participate in the auction in accordance with articles 51 ter (4) to (6) and article 51 quater (3) is sufficient to secure effective competition.

(2) If the number of suppliers or contractors registered to participate in the auction is in the opinion of the procuring entity insufficient to ensure effective competition, the procuring entity [shall] withdraw the electronic reverse auction.”

Commentary to article 51 quinquies above

38. The draft article is based on the provisions that were before the Working Group at its previous sessions as amended at the tenth session.¹⁸ In paragraph (2), the words “the number of suppliers or contractors registered to participate in the auction” replaced the previous wording “the number of suppliers or contractors at any time before the opening of the auction”, which was very broad.

39. The purpose of the draft article as revised is to ensure that the procuring entity keeps in mind the requirement of effective competition (see draft article 22 bis (b) above) at the stage of issuing invitations to participate in the auction, where applicable, and after a deadline for the registration to participate in the auction has expired, when it has a number of suppliers or contractors registered to participate in the auction.

40. In accordance with paragraph (2) of the draft article, the procuring entity's decision to withdraw the auction for the reasons that no effective competition can be ensured has to be based not on the number of invited suppliers or contractors but on the number of suppliers or contractors registered to participate in the auction. This requirement is especially relevant where suppliers or contractors are invited to participate in the auction through the notice of the electronic reverse auction in accordance with draft article 51 ter (3): paragraph (1) of draft article 51 quinquies in such case is not applicable because no separate invitations to participate in the auction are issued.

41. In paragraph (2), the word “shall” is in square brackets, for further consideration by the Working Group. At the tenth session of the Working Group, it was noted that an approach of requiring withdrawal of the auction was too prescriptive compared with a more flexible approach taken in some jurisdictions.¹⁹

“Article 51 sexies. Requirements during the auction

(1) During an electronic reverse auction:

(a) All bidders shall have an equal and continuous opportunity to submit their bids;

(b) There shall be automatic evaluation of all bids;

¹⁸ Ibid., para. 52, under (viii), and para. 53, article 47 bis (7).

¹⁹ Ibid., para. 52, under (viii).

(c) The [results of the auction/ranking of the bidders] [according to the pre-disclosed formula] must instantaneously be communicated on a continuous basis to all bidders;

(d) There shall be no communication between the procuring entity and the bidders, other than as provided for in paragraphs 1 (a) and (c) above.

(2) The procuring entity shall not disclose the identity of any bidder [until the auction has closed]. [Articles 33 (2) and (3) shall not apply to a procedure involving an electronic reverse auction].

(3) The auction shall be closed in accordance with the criteria specified in the notice of the electronic reverse auction or in the invitation to participate in the auction, as the case may be.

(4) [The procuring entity may suspend or terminate the electronic reverse auction in the case of system or communications failures.]”

Commentary to article 51 *sexies* above

42. The draft article is based on the provisions that were before the Working Group at its previous sessions as amended at the tenth session.²⁰

Paragraph (1)

43. In paragraph 1 (a), the words “submit their bids” replaced the words “revise their tenders in respect of those features presented through the auction process”. It is suggested as being broader and more accurate to cover various situations, including where no revision of bids through ERA takes place as no initial bids are submitted.

44. Subparagraph (c) has been put in the passive to reflect situations when third parties on behalf of the procuring entity manage ERAs.²¹ As regards the wording in the first pair of square brackets in that subparagraph, the Working Group decided to consider at its next session whether the reference should be to “the results” of the ERA or to “the ranking” of the bidders.²² The latter seems to be more accurate as the reference to the results is more appropriate in the context of final results at the closing of the auction.

45. The second pair of the square brackets in subparagraph (c) has been inserted by the Secretariat to indicate that the reference to a formula will not be appropriate in all cases. In a simple ERA, where the price is the only award criterion, no formula exists. The Working Group may consider deleting these words as being superfluous in the light of the provisions of article 51 *ter* (2)(b) and through a cross-reference in article 51 *quater* (1).

46. The Working Group may wish to consider replacing subparagraph (c) with the following wording that draws on the provisions of the European Union Directive 2004/18/EC, article 54, paragraph 6: “Sufficient information to enable the bidders to ascertain their relative ranking at any moment must instantaneously be communicated on a continuous basis to all bidders.”

²⁰ Ibid., paras. 57-63.

²¹ The previous wording was “Procuring entities must instantaneously communicate [the result] of the auction according to the pre-disclosed formula to all bidders on a continuous basis during the auction”. See *ibid.*, para. 62, article 47 *ter* (1)(b).

²² Ibid., para. 63.

Paragraph (2)

47. As regards the wording in the first square brackets in paragraph (2), the Working Group, at its tenth session, decided to consider at a future session whether to require that the anonymity of the bidders should be preserved after the closure of the auction.²³

48. As regards the wording in the second pair of square brackets in that paragraph, the Working Group decided at its tenth session that it would revisit at a future session the issue of whether the references to articles 33 (2) and (3)²⁴ should appear in that paragraph, or be replaced with language that would reflect more clearly the use of ERAs.²⁵ The Working Group may wish to consider that, in the absence of a cross-reference to article 33 (2) and (3) in draft articles above, provisions of article 33 (2) and (3) will not apply to ERAs in any case and therefore these words may be superfluous and should be deleted.

Paragraph (4)

49. The entire paragraph (4) was put in the square brackets pending the determination by the Working Group of whether to retain the provision and, if so, what its contents should be, so as to capture only those events that would justify the suspension or termination of an ERA.²⁶ In this connection, the Working Group may wish to note that suspension of ERAs may be needed in the case of the price justification if an abnormally low bid is submitted (see A/CN.9/WG.I/WP.50, paragraphs 43-49). In addition, article 56 of the Model Law provides for seven-day suspension of procurement proceedings in the case of the submission of complaints. This duration may be excessive and require reconsideration in the context of ERAs.

“Article 51 septies. Award of the procurement contract on the basis of the results of the electronic reverse auction

(1) The procurement contract shall be awarded to the bidder that, at the closure of the auction, submitted the bid with the lowest price or is ranked first, as applicable, except:

- (a) When such bidder fails to:
 - (i) Demonstrate its qualifications in accordance with article 6 when required to do so; or
 - (ii) Sign a written procurement contract if required to do so; or
 - (iii) Provide any required security for the performance of the procurement contract; and
- (b) In the circumstances referred to in articles 12, [12 bis] and 15.

(2) In the circumstances referred to in paragraph 1 (a) and (b) of this article, and subject to the right of the procuring entity, in accordance with

²³ Ibid., para. 60.

²⁴ The provisions of paragraph (2) of the article refer to the presence of suppliers or contractors that have submitted tenders, or their representatives, at the opening of tenders. They are being revised in the light of electronic means of communication (see A/CN.9/WG.I/WP.50, paras. 30 and 31). The provisions of paragraph (3) refer inter alia to the public announcement of the name and address of each supplier or contractor whose tender is opened and the tender price.

²⁵ A/CN.9/615, para. 61 (iii), the second part.

²⁶ Ibid., para. 61, under (iv).

article 12 (1) of this Law, to reject all remaining bids, the procuring entity may:

- (a) Hold another auction under the same procurement proceedings; or
 - (b) Announce new procurement proceedings; or
 - (c) Award the procurement contract to the bidder that, at the closure of the auction, submitted the bid with the second lowest price or is ranked second, as applicable.
- (3) Notice of acceptance of the bid shall be given promptly to the bidder that submitted the accepted bid [as well as to other bidders specifying the name and address of the bidder whose bid has been accepted and the bid price].”

Commentary to article 51 septies above

50. The draft article is based on the provisions that were before the Working Group at its previous sessions as amended at the tenth session (see, however, paragraphs 55-56 below).²⁷ The revisions have been made to streamline the text and align some of its provisions with similar provisions of the Model Law, such as those found in articles 34 (7) and 36 (5).

Paragraph (1)

51. Paragraph (1) of the draft text above intends to indicate that the auction must be the final stage in the procurement proceedings under the Model Law, after which no evaluation of bids can take place.²⁸ Therefore, as a general rule, the results of the auction must be final and binding upon the procuring entity and the lowest price obtained through the auction must figure in the procurement contract.

52. Exceptions to this rule are provided in subparagraphs (a) and (b). They were drafted on the basis of articles 34 (3)(a) and (d), 34 (7) and 36 (1) and (5) of the Model Law.

53. The reference in subparagraph (b) to article 12 bis is to draft provisions on abnormally low tenders, proposals, offers, quotations or bids, which are proposed to the Working Group at its eleventh session as draft article 12 bis (see document A/CN.9/WG.I/WP.50, the text following paragraph 45. The provisions of draft article 12 bis there enable the procuring entity to reject an abnormally low bid under some conditions).

54. The reference in the same subparagraph to article 15 is to the provisions of the Model Law that allow the procuring entity to reject the tender on the basis of inducements from suppliers or contractors. It corresponds to the reference found in article 34 (3)(d). In the light of the Working Group’s decision to strengthen anti-corruption provisions and regulate conflict of interests in the Model Law, provisions of article 15 may be expanded.

Paragraph (2)

55. At the Working Group’s tenth session, it was suggested that the procuring entity might not award a procurement contract to another bidder of the same auction if it decides that conditions prevent it from awarding the contract to the successful

²⁷ Ibid., para. 62, article 47 ter (5) and (6).

²⁸ Ibid., para. 55 (ii).

bidder. It was suggested that in such case, the procuring entity must cancel the results of the auction and may hold a new auction under the same procurement proceedings or announce new procurement proceedings.²⁹

56. Such prescriptive provisions may have disruptive and costly effects on the procurement proceedings. Paragraph (2) above was drafted in a more flexible manner to allow various options at the discretion of the procuring entity. Risks of each option may be explained in the Guide.

Paragraph (3)

57. Paragraph (3) is new and draws on article 36 (1) and (6) of the Model Law. The provisions in square brackets depend on the Working Group's decision on whether anonymity of bidders must be preserved after the auction (see draft article 51 *sexies* (2) and paragraph 47 above).

2. Proposed draft text for the revised Guide

58. The draft text for the Guide to accompany provisions of the Model Law on the procedural aspects of ERAs was presented by the Secretariat to the Working Group at its eighth session in document A/CN.9/WG.I/WP.40 (the text following paragraphs 25 and 35). At that and subsequent sessions, the Working Group did not consider the suggested text in the light of the revisions made to the draft articles on ERAs, which necessitated consequential changes to that text.

59. The new text for the Guide, which will replace in entirety the previously proposed text, will be prepared and presented to the Working Group at a future session, taking account of the Working Group consideration of the draft articles above.

D. Consequential changes to other provisions of the Model Law

1. Previously suggested changes to provisions of chapter III "Tendering proceedings" (articles 27, 31, 32 and 34)

60. In compliance with the Working Group's understanding at its tenth session that ERAs could be used not only in tendering but also in other procurement methods and as a stand-alone ERA,³⁰ this note does not suggest making changes to articles 27, 31, 32 and 34 of the Model Law applicable to tendering proceedings, and to the accompanying provisions of the Guide. Instead, the issues considered in conjunction with those articles have been addressed in articles 51 *bis* to *septies* above as follows:

Contents of solicitation documents (article 27)

61. The suggested changes to article 27 have been incorporated in draft article 51 *ter* above and by cross-reference in draft article 51 *quater*.

²⁹ Ibid., paras. 61 under (vi) and 62 article 47 *ter* (6).

³⁰ Ibid., paras. 37, 50, 59 and 64.

Period of effectiveness of tenders; modification and withdrawal of tenders (article 31)

62. At its tenth session, the Working Group decided to look at a future session into the question of how and when bids in the context of ERAs could be modified or withdrawn.³¹ Currently, the Model Law regulates the subject explicitly only in the context of tendering proceedings (article 31).

63. Draft article 51 ter (6), which deals with situations where ERA is preceded by assessment or evaluation of initial bids, incorporates provisions of article 31 by cross-reference. The Working Group may wish to consider whether the provisions of article 31 should be extended to offers in competitive negotiations and to quotations in request of quotations proceedings when ERAs are used under article 51 quater. Currently, the Model Law does not regulate the subject in the context of those procurement proceedings (see articles 49 and 50).

Tender securities (article 32 of the Model Law)

64. At its tenth session, the Working Group noted that tender securities were not often used in the specific context of ERAs. Views differed as to whether the Guide should discourage requiring tender securities in the context of ERAs, or whether a more flexible approach would be desirable (in that requiring a tender security could serve as a disincentive to withdraw the bid before the opening of the auction).³² At the eighth session, it was suggested that the Guide should note that practices might continue to evolve, as more relevant experience was accumulated.³³

65. Currently, the Model Law regulates the subject explicitly only in the context of tendering proceedings (article 32). Draft article 51 ter (6) above, which, as already noted, deals with situations where ERA is preceded by assessment or evaluation of initial bids, incorporates provisions of article 32 by cross-reference. If the Working Group decides to envisage explicitly that tender securities could be required in other cases, a cross-reference to article 27 (1) should be added to draft article 51 ter (2)(a) above.

Examination, evaluation and comparison of tenders (article 34)

66. At its tenth session, the Working Group agreed that the following wording would be considered at a future session as a change to the current article 34 (1)(a): “No change in a matter of substance in the initial tender, including changes in price, shall be sought, offered or permitted, except during the auction itself”. That wording would ensure, it was said at that session, that changes to tenders in ERAs would be permitted only during the auction phase itself, and would avoid giving the impression that changes could be made during the auction phase to make unresponsive tenders responsive.³⁴

67. Since article 34 is applicable to tendering proceedings alone, the Working Group may wish to reconsider amending this article because such amendment would be necessitated solely by the distinct features of ERAs. The Working Group may consider that a cross-reference to article 34 (1) in the context of assessment or

³¹ Ibid., para. 65.

³² Ibid., para. 69.

³³ A/CN.9/590, para. 100.

³⁴ A/CN.9/615, para. 71.

evaluation of initial bids in draft article 51 ter (6) above, and possibly additional explanation in the Guide, would sufficiently cover the point.

2. Record of procurement proceedings (article 11 of the Model Law)

68. At its tenth session, the Working Group decided to revisit the question of what information should be reflected in the record of procurement in conjunction with the use of ERAs.³⁵ The following proposed addition to article 11 of the Model Law was before the Working Group at its previous sessions:³⁶

“Article 11. Record of procurement proceedings

(1) The procuring entity shall maintain a record of the procurement proceedings containing, at a minimum, the following information:

...

[new paragraph] “In procurement proceedings involving the use of electronic reverse auctions pursuant to [article 22 bis], a statement to that effect.”

69. The location of the provisions on ERAs in article 11 is to be considered in conjunction with the Working Group decision on what information should be reflected in the record of procurement proceedings in the context of ERAs, and in the light of the Working Group’s decision at the tenth session that ERAs can be used not only in tendering proceedings.

³⁵ Ibid., para. 65.

³⁶ A/CN.9/WG.I/WP.43, para. 59, and A/CN.9/WG.I/WP.40/Add.1, para. 3.

**G. Note by the Secretariat on possible revisions to the UNCITRAL
Model Law on Procurement of Goods, Construction and Services
— drafting materials for the use of framework agreements and
dynamic purchasing systems in public procurement,
submitted to the Working Group on Procurement
at its eleventh session
(A/CN.9/WG.I/WP.52 and Add.1) [Original: English]**

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I. Introduction

1. The background to the current work of Working Group I (Procurement) on the revision of the UNCITRAL Model Law on Procurement of Goods, Construction and Services (the “Model Law”) (A/49/17 and Corr.1, annex I) is set out in paragraphs 5 to 65 of document A/CN.9/WG.I/WP.49, which is before the Working Group at its eleventh session. The main task of the Working Group is to update and revise the Model Law, so as to take account of recent developments, including the use of framework agreements, in public procurement.

2. Such use was included in the topics before the Working Group at its sixth to tenth sessions. At its tenth session, the Working Group requested the Secretariat to prepare drafting materials for consideration at the eleventh session, in the form of

broad enabling provisions that would accommodate any type of framework agreements. This note has been prepared pursuant to that request.¹

3. This note and addendum thereto draw on the consideration of framework agreements and dynamic purchasing systems set out in A/CN.9/WG.I/WP.44 and Add.1, and should be read together with those documents. Section II of this note sets out draft provisions for the use of framework agreements. Section III sets out draft provisions for the use of dynamic purchasing systems. Section IV sets out some considerations for consequential changes to the existing provisions of the Model Law to accommodate the use of framework agreements and dynamic purchasing systems. For sections III and IV, see the addendum A/CN.9/WG.I/WP.52/Add.1.

4. It is recalled that a framework agreement is a transaction to secure the supply of a product or service over a period of time. Further details are set out in paragraphs 3-6 of A/CN.9/WG.I/WP.44. It is also recalled that a dynamic purchasing system, as referred to in the European Union procurement directives,² is a totally electronic process permitted for making commonly used purchases. Further details are set out in paragraph 35 of A/CN.9/WG.I/WP.44/Add.1.

II. Draft provisions to enable the use of framework agreements in public procurement under the Model Law

A. Terminology

5. Questions of terminology and interpretation of terms are addressed in paragraphs 7-9 of A/CN.9/WG.I/WP.44. The Working Group is requested to consider the name that the Model Law should use to refer to “framework agreements” (that is the term used in the English language version of the European Union Procurement Directives,³ and in some domestic systems). Alternatives considered in the paragraphs referred to above include terms that are not closely identified with any particular system such as “periodic purchase arrangement”, “recurrent purchase arrangement”, “periodic requirements arrangement” or “periodic supply vehicle”. Pending a decision on this question, and consistent with previous notes on the topic, this note will refer to “framework agreements”.

¹ A/CN.9/615, paras. 11 and 79 to 81. The Working Group noted in addition that the main issues of substance to be considered include whether specifications can be altered within the operation of the framework agreements, and whether suppliers not parties to the original framework agreement could join it after the conclusion of the master contract.

² Directive 2004/17/EC of the European Parliament and of the Council of 31 March 2004 coordinating the procurement procedures of entities operating in the water, energy, transport and postal services sectors, and Directive 2004/18/EC of the European Parliament and of the Council of 31 March 2004 on the coordination of procedures for the award of public works contracts, public supply contracts and public service contracts, both available as of the date of this note at http://ec.europa.eu/internal_market/publicprocurement/legislation_en.htm.

³ Ibid.

B. Scope of the draft provisions and approach to drafting

6. This section addresses two models of framework agreements:

(a) “Model 1” framework agreements, which are very similar to traditional procurement contracts. They can be concluded with one or more suppliers or contractors, and establish the specification for the procurement and all the terms and conditions of the procurement. Purchase orders are placed under them on the basis of those specifications and fixed terms and conditions of the procurement without any further evaluation or competition. Thus the only difference of this type of framework agreements as compared with traditional procurement contracts is that the items are procured in batches, under purchase orders, over a period of time; and

(b) “Model 2” framework agreements are agreements concluded with more than one supplier or contractor (the first stage of the procurement), which set out the specification for the procurement, and the main terms of the procurement. They may leave some terms of the procurement undecided or subject them to further evaluation (these terms could include price, and normally include quantities and delivery times). A further evaluation or competition among the suppliers or contractors that are parties to the framework agreement is required to select the suppliers or contractors to fulfil each purchase order placed under the framework agreement (the second stage of the procurement). Although in theory framework agreements of this type could also be concluded with one supplier that would be invited to improve its offer for a particular purchase order, commentators have indicated that the risk of abuse is significant and therefore single-supplier framework agreements of this type have not been provided for in this note.

7. In the draft provisions contained in this section, it is the purchase orders issued under both Models of framework agreements, and not the framework agreements themselves, that constitute procurement contracts.^{4, 5} This approach allows the regulation of both Models in a single set of provisions (see subsection D below) and thus achieves:

(a) Consistency in regulation and avoidance of repetitive listing of some considerations that are applicable to both Models; and

⁴ The requirements for the formation of a binding contract are outside the scope of the Model Law. Nevertheless, article 2 (g) of the Model Law provides the following definition of the procurement contract: “‘Procurement contract’ means a contract between the procuring entity and a supplier or contractor resulting from procurement proceedings.” Other provisions of the Model Law (see in particular articles 34 and 36) indicate that only when all terms and conditions are set and the suppliers are selected can a procurement contract come into force. Therefore, Model 1 framework agreements could (and perhaps should) be construed as procurement contracts as defined in article 2 (g) of the Model Law and within the terms of current article 36 (1) and (4). As regards Model 2 framework agreements, although it is not precluded in some jurisdictions that an agreement without all terms fixed could be construed as a contract, under the Model Law, Model 2 framework agreements, which subject some or all terms and conditions to further evaluation, are not procurement contracts *strictu sensu*.

⁵ If framework agreements are treated as procurement contracts, the issue of purchase orders would fall under the contract administration stage and thus outside the scope of the Model Law. The Working Group, at its previous sessions, considered whether the scope of the Model Law should be expanded to cover also contract administration stage. No consensus has been reached on that issue; however, the prevailing view has been so far that such an expansion would be undesirable. See A/CN.9/590, para. 13, and A/CN.9/595, paras. 80-86.

(b) The continuing application of the Model Law's transparency and objectivity provisions, and of other safeguards, until the placement of the purchase orders, i.e., for all phases up to the award of procurement contracts based on the framework agreement.

8. This approach also alleviates the need to amend a number of provisions throughout the Model Law so as to accommodate framework agreements within existing procurement methods. The relevant provisions of the existing Model Law are made applicable to framework agreements through cross-references. Where necessary, derogations from those provisions are provided for. For an alternative approach to drafting, see subsection E below.

C. Location of the draft provisions

9. Pending the Working Group's consideration of the structure of the revised Model Law, and as to whether framework agreements could result from procurement proceedings by means of any procurement method envisaged under the Model Law, the provisions for framework agreements are presented in this note as three draft articles to be included in a composite draft section on framework agreements, located in Chapter V (following the procedures for the conduct of electronic reverse auctions).⁶ The draft articles will be finally numbered once the structure of Chapter V is finalized.

D. Proposed draft text for the revised Model Law — Models 1 and 2 framework agreements

10. The Working Group may wish to recall its request to the Secretariat that the provisions be drafted so as to provide appropriate safeguards including as against collusion and anti-competitiveness.⁷ The Working Group may also wish to consider the observations of commentators that true competition when issuing purchase orders under a Model 2 framework agreement may be difficult to achieve.⁸ Therefore, the draft provisions below draw on systems for Model 2 framework agreements that envisage the competition at both stages of the procurement proceedings, i.e. for the conclusion of the framework agreement and for the award of procurement contracts under the framework agreement,⁹ rather than on systems that envisage the main competition at the second stage, without any meaningful competition at the first stage (i.e. for conclusion of a framework agreement itself). Also recalling that there may be risks to competition in operating a framework agreement for an extended period of time, the provisions draw on systems that limit their duration.¹⁰ The main sources are therefore the European Union public

⁶ The Working Group may consider that framework agreements are techniques that can be applied in various procurement methods, rather than a procurement method per se. This consideration applies also to electronic reverse auctions (see A/CN.9/WG.I/WP.51, paras. 3-5).

⁷ A/CN.9/615, para. 81.

⁸ See, further, A/CN.9/WG.I/WP.44/Add.1, paras. 41 and 42.

⁹ In Model 1 framework agreements, there is no further competition after the first stage between the suppliers or contractors, but the procuring entity is obliged to select the tender or other submission that is the lowest price or lowest evaluated tender or equivalent at the second stage.

¹⁰ See, further, A/CN.9/WG.I/WP.44, paras. 16 and 17.

procurement directive 2004/18/EC (articles 1 (5) and 32) (hereinafter “the EU Procurement Directive”), and the applicable provisions of the current Model Law:

“Section [...]. Framework agreements

Article [51 octies]. General provisions

(1) A procuring entity may enter into a framework agreement with one or more suppliers or contractors [, the aggregate value of which is anticipated to exceed [*the enacting State includes a minimum amount*] [but not to exceed [*the enacting State includes a maximum amount*] [the amount set out in the procurement regulations]].

(2) A framework agreement shall set out the terms and conditions upon which suppliers or contractors are to supply the goods, construction and services, and the procedures for the award of procurement contracts under the framework agreement. A framework agreement is not a procurement contract within the meaning of article 2 (g) of this Law.

(3) If the terms and conditions of the framework agreement provide for a competitive procedure for the award of procurement contracts under the framework agreement, the procuring entity shall ensure that the number of suppliers or contractors that are parties to the framework agreement is sufficient to secure effective competition when procurement contracts under the framework agreement are awarded.

(4) A framework agreement shall be concluded for a given duration, which is not to exceed [...] years [, save in exceptional cases, by reference to the goods, services or construction procured under the framework agreement, for no longer than [...] years. The procuring entity shall include in the record required under article 11 of this Law a statement of the grounds and circumstances on which it relied to justify [the extension of the duration of the framework agreement] [the longer duration of the framework agreement.]]

Commentary and issues for discussion in the Guide to Enactment

Paragraph (1)

Joint purchasing

11. To enable a procuring entity to group its procurement requirements to take advantage of bulk purchasing discounts, either by procuring together with other procuring entities or through a central purchasing entity,¹¹ the definition of a procuring entity in article 2 (b) of the Model Law needs to be amended. The amended wording is suggested below:

¹¹ This would also allow for the entity concluding a framework agreement not to be the procuring entity awarding the procurement contracts based on that framework agreement (for example, in the case of the purchase of school books from publishers selected by an education ministry, followed by purchases made by the schools districts or schools themselves, or a similar structure for pharmaceutical products for hospitals).

“‘Procuring entity’ means:

Option I

Any governmental department, agency, organ or other unit, or any subdivision thereof, in this State that engages in procurement, either alone, together with other procuring entities [or through [an enacting State may insert a reference here to a central purchasing entity]], except ...;

(and)

Option II

Any department, agency, organ or other unit, or any subdivision thereof, of the (“Government” or other term used to refer to the national Government of the enacting State) that engages in procurement, either alone, together with other procuring entities [or through [an enacting State may insert a reference here to a centralized purchasing entity]], except ...;

Conditions for the use of framework agreements

12. Paragraph (1) includes optional text for the enacting State to specify the minimum and maximum anticipated size of procurement for which framework agreements may be suitable, either in the Model Law text or in regulations. Alternatively, the issue could be addressed in the Guide to Enactment. The Working Group may wish to consider whether such a provision is desirable (to promote cost-effectiveness and avoid over- or inappropriate use of the procedure) together with the question of which procurement methods should be permitted to lead to a framework agreement, as discussed in paragraphs 18 and 19 below.¹²

13. The Working Group may also wish to consider that the Guide should elaborate on the effective and appropriate use of framework agreements, perhaps including a list of generic procurement that would be suitable for procurement in this fashion and some case studies. Framework agreements may be less suitable for large investment or capital contracts, for very technical or complex items, and more complex services procurement, topics that could also be discussed in the Guide.

Paragraph (2)

14. The wording complies with the approach to drafting explained in paragraph 7 above.¹³ The provisions in this and subsequent articles according to the context refer to the award of procurement contracts under both Model 1 and Model 2 framework agreements.

Paragraph (3)

15. The text reflects the practice that framework agreements are commonly concluded with more than one supplier. To ensure effective competition, the Working Group may consider that a Model 2 framework agreement should be awarded to a minimum number of suppliers. The EU Procurement Directive requires the equivalent minimum number to be three. Alternatively, and considering that the

¹² If the Working Group considers that a minimum and maximum estimated amount for purchases for the use of a framework agreement should be included, the question of price inflation could also be addressed, through the provision of an index or similar calculation mechanism.

¹³ See also footnote 4, *supra*.

risk of collusion among low numbers of suppliers may exist, the Working Group may wish to consider a more general requirement set out in the draft article above to ensure effective competition, consistent with the approach taken in drafting similar provisions related to electronic reverse auctions.¹⁴

Paragraph (4)

16. Framework agreements are closed systems, meaning that no supplier or contractor may be awarded a procurement contract under the framework agreement without being party to the framework agreement. They are closed to other suppliers for the period of their duration. Paragraph (4) seeks to address the concerns that have been voiced about this potentially anti-competitive feature of framework agreements by limiting their duration (see, further, paragraphs 16-18 of A/CN.9/WG.I/WP.44 for a discussion of those concerns). The Working Group's attention is drawn to provisions of the EU Procurement Directive that limit the duration of frameworks to four years in normal circumstances (exceptions are permitted with appropriate justification). The Working Group may wish to consider inserting the maximum length of framework agreements in the text of the Model Law, rather than leaving the matter to procurement regulations or other rules. The Working Group may also wish to consider whether an explicit reference to an extension in the text may be seen as inviting exceptions by legislation.

17. The issue of the duration of framework agreements is closely linked to the issue of the procuring entity's ability to purchase outside the framework agreement, discussed in paragraphs 24-26 below in conjunction with draft article 56 decies (1). The Working Group may therefore wish to consider both issues together.

Article [51 novies]. Conclusion of framework agreements

(1) Where a procuring entity intends to enter into a framework agreement, it shall follow the procedures of this Law applicable to the procurement method chosen for solicitation of tenders, proposals, offers or quotations (collectively referred to as "submissions" in this section), so as to select the supplier(s) or contractor(s) with which it will conclude the framework agreement.

(2) When first soliciting the participation of suppliers or contractors in the procurement proceedings, the procuring entity shall specify all information required for the chosen procurement method under this Law, except to the extent that those provisions are derogated from in this article, together with the following information:

(a) A statement that the procurement will involve a framework agreement;

(b) The nature, estimated quantity and desired place and time of delivery, of the purchases envisaged under the framework agreement;

(c) The number or the minimum and maximum number of supplier(s) or contractor(s) to be parties to the framework agreement;

(d) The criteria to be used by the procuring entity in the selection of the supplier(s) or contractor(s) with which it will enter a framework agreement,

¹⁴ See in document A/CN.9/WG.I/WP.51, articles 22 bis and 51 quinquies and commentaries thereto.

including their relative weight and the manner in which they will be applied in the selection, and whether the selection will be based on lowest price or lowest evaluated submission;

(e) If the procuring entity intends to enter into a framework agreement with more than one supplier or contractor, that the supplier(s) or contractor(s) selected for the framework agreement will be ranked according to the selection criteria specified;

(f) The terms and conditions of the framework agreement upon which supplier(s) or contractor(s) are to supply the goods, construction and services, including the duration of the framework agreement and:

(i) The procedure for the award of procurement contracts on the basis of the framework agreement, in particular whether a further competition will be held;

(ii) If further competition for the award of procurement contracts is to be held among suppliers or contractors parties to the framework agreement, the criteria for evaluating the submissions during that competition, their relative weight, the manner in which they will be applied in the evaluation of the submissions, and whether the award of procurement contracts will be based on lowest price or lowest evaluated submission; and

(iii) If an electronic reverse auction will take place, in addition information referred to in article [cross-reference to the relevant provisions on electronic reverse auctions];

(g) Whether a written framework agreement will be required and the manner of entry into force of the framework agreement.

(3) Unless the procuring entity rejects some or all submissions under articles [12, 12 bis, other cross-references] of this Law, the procuring entity shall select the supplier(s) or contractor(s) with whom to enter into the framework agreement on the basis of the selection criteria to be specified under paragraph (2) (d) above, and shall promptly notify the selected supplier(s) or contractor(s) of their selection and, where relevant, their ranking.

(4) The framework agreement, on the terms and conditions of the selected submission(s) comes into force as specified in accordance with the requirements of paragraph (2) (g) above.

(5) The procuring entity shall promptly publish notice of the award of the framework agreement, in any manner that has been specified for the publication of contract awards under article 14 of this Law.

Commentary and issues for discussion in the Guide to Enactment

Paragraph (1)

18. Paragraph (1) permits framework agreements to be concluded with one or more suppliers or contractors following the procurement methods specified in the Model Law. Since one concern that arises in framework agreements is the possible restriction of competition during their operation, the Working Group may consider that a framework should normally be concluded only after fully open procurement

proceedings, so as to ensure rigorous competition at that first stage of the procurement proceedings. On the other hand, oft-cited beneficial use of framework agreements include the ability to protect sources of supply in limited markets, and the swift and cost-effective procurement of low-cost, repeated and urgent items, such as maintenance or cleaning services, for which open tendering procurements may not be cost-effective.¹⁵

19. If the Working Group considers that framework agreements may result from procurement proceedings by means of any procurement methods specified in the Model Law (including the principal method for procurement of services, two-stage tendering, restricted tendering, request for proposals, competitive negotiation, and request for quotations, though perhaps excluding single-source procurement), the Working Group may wish to provide guidance in the Guide regarding the types of procurement that are suitable for each procurement method, and that the Guide should stress the need for the most competitive process in the circumstances. The Working Group may also wish to consider whether two-stage tendering, which is normally used for very complex or large capital procurement, would be suitable.

Paragraph (2)

Transparency provisions

20. The paragraph intends to achieve the following objectives: first, to apply the main transparency requirements for the procurement method chosen to select the suppliers or contractors for the framework agreement (such as those set out in articles 25, 27, 37 and in various articles in Chapter V, and the provisions of proposed article on communications in procurement proceedings being considered by the Working Group);¹⁶ secondly, to set out deviations from those requirements in the light of the specific requirements of the framework agreements (see, for example, draft article 51 novies 2 (b) that refers to estimated quantities as compared to article 27 (d), and draft article 51 novies 2 (d), (f) and (g) that supersede articles 27 (e), (f) and (y)); and thirdly, to add other transparency-related requirements specific to framework agreements. The Working Group may consider this a more efficient method of drafting rather than amending other provisions of the Model Law that may be applicable (see also the drafting approach in this note explained in paragraph 8 above).

Selection criteria

21. Subparagraphs (d) and (f)(ii) draw on article 27 (e) of the Model Law that requires the solicitation documents for tendering proceedings to specify: “The criteria to be used by the procuring entity in determining the successful tender, including any margin of preference and any criteria other than price to be used pursuant to article 34 (4)(b), (c) or (d) and the relative weight of such criteria”. Equivalents to this requirement are found for other procurement methods. Requirements for selection criteria in tendering proceedings are found in article 34 (4)(b), which inter alia states that the “criteria shall, to the extent practicable, be objective and quantifiable, and shall be given a relative weight in the evaluation procedure or be expressed in monetary terms wherever practicable”. There is no equivalent to these requirements for other procurement methods. The

¹⁵ Other examples include purchase of coal, crude oil, drugs and textbooks, in each case with appropriate safeguards (including quality and competition requirements).

¹⁶ See A/CN.9/WG.I/WP.50, draft article 5 bis, following para. 4.

Working Group may wish to consider whether (to enhance objectivity and transparency) some or all of the objectivity requirements contained in article 34 (4)(b) should be set out in subparagraphs (d) and (f)(ii) for framework agreements above, by adding the following or similar text: “the criteria, which, to the extent practicable, shall be objective and quantifiable, and shall be given a relative weight or be expressed in monetary terms wherever practicable”. Alternatively, or additionally, the Working Group may consider that there should be transparency and objectivity requirements in the Model Law regarding selection criteria for all procurement methods (including framework agreements), in addition to the requirements for the solicitation documents or their equivalent as regards selection criteria. Finally, the Working Group may wish to consider whether the use of a margin of preference for framework purchasing would be suitable.

Paragraph (3)

22. The paragraph draws on articles 34 (4)(b) and 36 (1) of the Model Law. The cross-references currently in square brackets will be to provisions of the Model Law that allow procuring entity to reject tenders, proposals, offers, quotations or bids (see, for example, articles 12 and 15). The reference to article 12 bis is a reference to the draft article on rejection of tenders, proposals, offers, quotations or bids on the basis that they are abnormally low, proposed for consideration by the Working Group at its eleventh session.¹⁷

Paragraph (4)

23. Paragraph (4) should be read together with paragraph (2) (g) of the draft article above. The paragraph draws on the approach taken in article 13 (2) of the Model Law as regards the manner of entry into force of procurement contracts in procurement methods other than tendering proceedings. While in tendering proceedings the matter is regulated in article 36 (which also requires the prior “acceptance” of the successful tender), in other procurement methods, under article 13, the manner of entry into force of procurement contracts must be notified to the suppliers or contractors in the beginning of the procurement proceedings. The Working Group may wish to consider at a later date whether the provisions regarding acceptance of the successful tender or other submission and the entry into force of the procurement contract should be conformed.

Article [51 decies]. Award of procurement contracts under the framework agreement

- (1) The procuring entity may award one or more procurement contracts under the framework agreement in accordance with the terms and conditions of the framework agreement, subject to the provisions of this article.
- (2) No procurement contract under the framework agreement may be awarded to suppliers or contractors that were not originally party to the framework agreement.
- (3) In the process of awarding procurement contracts under the framework agreement, the parties to the framework agreement may not materially amend or vary any term or condition of the framework agreement.

¹⁷ Ibid., paras. 43-49.

(4) If the framework agreement is entered into with one supplier or contractor, the procuring entity may award a procurement contract on the basis of the terms and conditions of the framework agreement to the supplier or contractor party to that agreement by the issue of a purchase order [in writing] to that supplier or contractor. The procurement contract, on the terms and conditions of the framework agreement, comes into force when this purchase order is dispatched.

(5) If the framework agreement entered into with more than one supplier or contractor establishes all the terms and conditions necessary for the procurement to be effected [, and does not provide for a competitive procedure for the award of procurement contracts under it], the procuring entity may award a procurement contract by the issue of a purchase order [in writing] to the highest-ranked supplier(s) or contractor(s) capable of fulfilling the contract. The procurement contract, on the terms and conditions of the framework agreement, comes into force when this purchase order is dispatched. The procuring entity shall notify [in writing] all other suppliers and contractors that are parties to the framework agreement of the name and address of the supplier(s) or contractor(s) to whom the purchase order has been dispatched.

(6) If the framework agreement entered into with more than one supplier or contractor [does not establish all the terms and conditions necessary for the procurement to be effected] [provides for a competitive procedure for the award of procurement contracts under the framework agreement], the procuring entity may award a procurement contract under the framework agreement in accordance with the following procedures:

(a) The procuring entity shall invite [in writing] all suppliers or contractors that are parties to the framework agreement to present their submissions for the supply of the items to be procured;

(b) The invitation shall restate the terms and conditions of the framework agreement, and shall set out the terms and conditions of the procurement contract that were not specified in the terms and conditions of the framework agreement, and shall set out instructions for preparing submissions;

(c) The procuring entity shall fix the place for, and a specific date and time as the deadline for presenting the submissions. The deadline shall afford suppliers or contractors sufficient time to prepare and present their submissions;

(d) The successful submission shall be determined in accordance with the criteria set out in the framework agreement;

(e) Where an electronic reverse auction is held, the procuring entity shall comply with requirements during auction in article [cross-references to the relevant provisions];

(f) Without prejudice to the provisions of article [proper cross-reference to the provisions on award of contracts through electronic reverse auction] and subject to articles [12, 12 bis and other appropriate references] of this Law, the procuring entity shall accept the successful submission(s), and shall promptly notify [in writing] the successful supplier(s) or contractor(s) that it has accepted their submission(s). The procuring entity shall also notify [in writing] all other suppliers and contractors that are parties to the

framework agreement of the name and address of the supplier(s) or contractor(s) whose submission(s) was or were accepted and the contract price;

(g) The procurement contract(s), on the terms and conditions of the successful submission(s), comes into force when the notice of acceptance to the successful supplier(s) or contractor(s) is dispatched.

(7) Where the price payable pursuant to a procurement contract concluded under the provisions of this section exceeds [*the enacting State includes a minimum amount* [or] the amount set out in the procurement regulations], the procuring entity shall promptly publish notice of the award of the procurement contract(s) in any manner that has been specified for the publication of contract awards under article 14 of this Law. The procuring entity shall also publish, in the same manner, [quarterly] notices of all procurement contracts issued under a framework agreement.

Commentary and issues for discussion in the Guide to Enactment

Paragraph (1)

24. The Working Group may wish to consider whether the procuring entity must effect all purchases of the items concerned under the framework agreement through that framework agreement. In practice, it is common that no such obligation is imposed on the procuring entity, even under a Model 1 framework agreement, to enable the procuring entity to obtain the best value for money if, for example, market circumstances change and better offers exist outside the framework agreement.¹⁸ Paragraph (1) as drafted provides such flexibility to the procuring entity.

25. On the other hand, whether suppliers will discount their prices to give the maximum commercial benefit to procuring entities may in many cases depend on whether suppliers are confident that they will receive sufficient orders under the framework agreement, at least within the estimated quantities (minima and maxima) indicated in the agreement, to justify such discounts.¹⁹ If procuring entities are freely able to and regularly do procure the items concerned outside the framework agreement, suppliers' confidence may be eroded.

26. Accordingly, there may be actual and potential costs and benefits incurred in permitting or not permitting procuring entities to purchase outside the framework agreement. The Working Group may wish to formulate its position on the matter taking into account possible costs and benefits and the type of procurement at issue.

Paragraph (3)

27. This paragraph and those following have been drafted on the understanding that no material change to the terms and conditions of the framework agreement as set out in the beginning of the procurement proceedings is allowed at the subsequent

¹⁸ Another way is to allow technology-refreshing provisions, but such provisions may not be compatible with the requirement of fixed specifications under traditional framework agreements. Where generic specifications are used, for example, in certain types of standing qualification lists, such provisions may be considered.

¹⁹ See A/CN.9/WG.I/WP.44, paras. 11-15, for a discussion of the potential benefits of framework agreements, including efficiency and security of supply.

stage. This restrictive approach reflects a closed framework agreement system. Allowing changes in evaluation criteria or specifications at the stage of the award of procurement contracts under a framework agreement may lead to abuse, such as favouritism through procuring entity adapting criteria to the needs of any particular party to the framework agreement, and further exacerbates any anti-competitive effect of a framework agreement.²⁰

Paragraphs (4), (5) and (6)

[in writing]

28. The Working Group may wish to consider whether the provisions should require that the procuring entity must perform the referred actions, such as issue of purchase orders or invitation of, or notification to, suppliers of contractors, in writing (that is, on paper or electronically) as opposed by phone or otherwise verbally. Such an explicit requirement appears for example in the EU Procurement Directive. The issue may be considered in conjunction with article 5 bis on communications in procurement, set out in document A/CN.9/WG.I/WP.50 (the text following paragraph 4) (also before the Working Group at its eleventh session).

Acceptance of successful submission and entry into force of the procurement contract

29. The Working Group may note that the provisions mirror the equivalent provisions for tendering proceedings, rather than the more flexible approach for other procurement methods envisaged under article 13. Paragraph (6) (g) tracks the wording of article 36 (4), which refers to the procurement contract coming into force in accordance with the terms and conditions of the accepted tender. Whether this may be an accurate statement about the source of the terms and conditions of the procurement contract may be a further issue for the Working Group to consider when reviewing article 36 and the equivalent provisions for other procurement methods at a later date. (See also paragraph 23 above about possible need to conform the provisions regarding acceptance of the successful tender or other submission and the entry into force of the procurement contract throughout the Model Law).

Paragraphs (5) and (6)

Requirement for decision at the outset as to whether the multi-supplier framework agreement will be a Model 1 or Model 2 framework agreement

30. The paragraphs are drafted in such a way that the procuring entity cannot invite further competition at the second stage of the procurement proceedings unless the terms and conditions of the framework agreement disclosed in a solicitation notice in accordance with draft article 51 novies (2)(f) above advised that this would be the award procedure, and, conversely, that the procuring entity cannot award a procurement contract without competition if the terms and conditions of the framework agreement provided for second-stage competition. An alternative formulation would be to allow the procuring entity to decide subsequently after the

²⁰ These risks may be considered to be considerably higher in closed framework agreements than in open dynamic purchasing systems, where an unlimited number of potential suppliers are allowed to compete for the award of any particular procurement contract. See A/CN.9/WG.I/WP.52/Add.1.

first stage whether or not to hold a second-stage competition (provided that such a possibility has been reserved at the outset of the procurement proceedings in the terms and conditions of the framework agreement as disclosed in a solicitation notice). The Working Group may wish to consider whether the advantages of additional flexibility would be outweighed by a possible risk of abuse.

Possibility of competition on the same terms

31. The Working Group may wish to consider (i) whether the opening phrase in paragraph (5) of the draft article should contain the text in square brackets and (ii) which of the square bracketed texts or both (with the appropriate connector) should remain in the chapeau of paragraph (6). The decision would depend on the Working Group's position as regards possibility of holding second-stage competition even if all terms and conditions have been set out in the multi-supplier framework agreement, provided that such a possibility has been reserved at the outset of the procurement proceedings (see paragraph 30 above). In this regard, the attention of the Working Group is drawn to the provisions of the EU Procurement Directive that provide for such a possibility (see article 32 (4), the second indent).

Paragraph (6)

32. Paragraph (6) sets out procedures that will have to be followed at the second stage of competition. This latter procedure resembles tendering proceedings with the exception that no open solicitation is held; only suppliers that are parties to the framework agreement are notified about forthcoming awards. If an electronic reverse auction is held, additional provisions on electronic reverse auctions will be applicable and cross-references to those provisions have therefore been inserted.

33. The approach taken in drafting the provisions, which does not allow at the subsequent stage to change substantially the terms and conditions of the framework agreement as set out in the beginning of the procurement proceedings (see paragraph 27 above), would prevent the procuring entity from holding procedures at the second stage of competition that resemble two-stage tendering (article 46 (4)) or competitive negotiations proceedings (article 49), both of which permit material variations in specifications and evaluation criteria.

34. It is implicit under provisions of paragraph (6), which require inviting all suppliers or contractors that are parties to the framework agreement to present submissions at the second stage, that all suppliers admitted to the framework should be capable of carrying out the entire procurement concerned, so that the framework is effectively restricted in scope to a type or group of item(s) that all suppliers or contractors parties to the framework agreement are able to provide. In some jurisdictions, framework agreements broader in scope are concluded, so that the framework agreement may provide for a list of items that not all suppliers or contractors would be able to provide, or it may be evident that no one supplier could meet all the procuring entity's requirements. The procuring entity may therefore benefit from the flexibility to select the item(s) required and to invite only those suppliers to compete who can supply the items or combination. The Working Group may wish to consider whether the Model Law should provide for framework agreements of broad or narrow scope, bearing in mind the need to ensure effective competition and that one of the main goals and benefits of the framework agreements is to secure supplies. If the Working Group considers that only narrow-scope framework agreements should be permitted, it may wish to consider whether article 27 (h) (which envisages partial tendering) should be excluded in the

case of frameworks agreements, and whether tender securities may be required. If it wishes to provide for broader-scope agreements, the Working Group may wish to consider how the procuring entity could limit the numbers of suppliers or contractors invited to compete at the second stage.

Paragraph (7)

35. The Working Group may wish to consider in which cases the publication of notice of procurement contract awards under the framework agreement should be required, by reference in particular to the amount payable under the procurement contract in question.

36. The Working Group may also wish to consider whether requiring in addition the publication of advance public notices of intended procurement contracts may enhance proper oversight and review, and lead to better value for money procurement contracts (for example, by enabling procuring entities to be advised of better opportunities, and purchase, outside the framework agreement. See, however, paragraphs 24-26 above for issues regarding purchases outside the framework agreement).

E. Alternative approach to drafting

37. The Working Group may wish to consider an alternative approach to drafting, for example by regulating Model 1 framework contracts separately from Model 2 framework agreements, so as to reflect the more straightforward nature of the former. While Model 1 single-supplier framework contracts are sufficiently covered by the existing provisions of the Model Law, regulating Model 1 multi-supplier framework agreements separately would require amendments to a number of the Model Law provisions.

38. First, amendments would have to be made to article 2 (g) of the Model Law, which defines a procurement contract, to provide for a possibility of concluding procurement contracts with more than one suppliers or contractors. The provisions may read:

“*Procurement contract*” means a contract between one or more procuring entities and one or more suppliers or contractors resulting from procurement proceedings”.²¹

39. In addition and as linked thereto, to enable procuring entities to accept more than one tender or its equivalent, references throughout the Model Law to successful or accepted tender or proposal, best and final offer and lowest-priced quotation or to the supplier or contractor submitting them would have to be put in plural in a number of articles, such as in articles 11, 27 (e), 34 (4)(b), 36, 38-44 and 46-50, according to the context.

²¹ This amended definition would enable a procurement contract to be concluded with more than one supplier not only in the case of framework contracts. If the Working Group considers that procuring entities should not have the flexibility to accept more than one tender and conclude multiple party procurement contracts as a general proposition other than in the context of framework agreements, the words “in the case of framework agreements” can be inserted in the definition where appropriate.

40. Second, revisions throughout the current text of the Model Law would have to be made to provide for appropriate transparency, oversight and review procedures. Appropriate safeguards would need to be built in the Model Law to ensure: first, that procedures for allocation of purchase orders under the multi-supplier framework contracts are disclosed to suppliers in the beginning of the procurement proceedings; and second, that the suppliers parties to the framework agreement will have means to verify that such procedures were indeed followed (by requiring, for example, that, once purchase orders are allocated, the suppliers parties to the framework agreement must be notified of allocated purchase orders and to whom they were allocated). While there would be no difficulty in incorporating in the Model Law the requirement to disclose in the beginning of the procurement proceedings the procedures on allocation of purchase orders under the framework contract (through additions to article 27 and equivalent articles regulating other procurement methods), there may be greater difficulty in providing for effective oversight and review, as such provisions would then be applied to the contract administration stage.²² Furthermore, the question would be raised as to why other long-term or large-scale procurement would also not be subject to similar provisions at the contract administration phase. The Working Group has not yet decided whether the Model Law should regulate this phase of procurement.²³

²² See footnote 5, *supra*.

²³ *Ibid*.

A/CN.9/WG.I/WP.52/Add.1 [Original: English]

**Note by the Secretariat on possible revisions to the UNCITRAL
Model Law on Procurement of Goods, Construction and Services
— drafting materials for the use of framework agreements and
dynamic purchasing systems in public procurement, submitted to
the Working Group on Procurement at its eleventh session**

ADDENDUM

[Chapters I and II are published in document A/CN.9/WG.I/WP.52]

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III. Draft provisions to enable the use of dynamic purchasing systems in public procurement under the Model Law

A. Scope and terminology

1. This section deals with an electronic purchasing arrangement with the main characteristics of Model 2 framework agreements described in document A/CN.9/WG.I/WP.52, but new suppliers or contractors can be admitted to the system at any time, and all suppliers or contractors admitted to the system may revise their tenders at any time (without a new tender phase). This type of arrangement is substantively different from Models 1 and 2 framework agreements because of these features, and the Working Group may wish therefore to regulate them, if at all, separately.

2. Variations of such systems can be encountered in practice, which differ from each other mainly by the extent to which changes to the specifications of the system are allowed (at the most extreme, only generic specifications may be provided,

which are refined or further defined when a procuring entity wishes to make a purchase). Some are paper-based, but most operate electronically as electronic catalogues, or electronic purchasing systems. Although called framework agreements in some jurisdictions, such arrangements may be more appropriately described as standing qualification lists, especially where only generic specifications may be provided.¹ For controls commonly imposed on such lists, see notes by the Secretariat on suppliers' lists (A/CN.9/WG.I/WP.45 and Add.1).

3. The Working Group may wish to base any provisions for regulating such systems in the Model Law on provisions for the "dynamic purchasing system" in the European Union public procurement directive 2004/18/EC (articles 1 (6) and 33) (hereinafter "the EU Procurement Directive"),² which is not based on a generic specification and so is not in essence a suppliers' list.

4. As regards the terminology for the system, pending the Working Group's decision on this question, and consistent with previous notes on the topic, this note will refer to "dynamic purchasing systems" (that is the term used in the English language version of the EU Procurement Directive).

B. Location of draft provisions

5. Pending the Working Group's consideration of the structure of the revised Model Law, the provisions for dynamic purchasing systems are presented in this note as three draft articles to be included in a composite draft section on dynamic purchasing systems, located in Chapter V (following the provisions on framework agreements).³ The draft articles will be finally numbered once the structure of Chapter V is finalized.

C. Proposed draft text for the revised Model Law

6. Suggested provisions, which draw on the EU Procurement Directive but are drafted to be consistent with those proposed for framework agreements in document A/CN.9/WG.I/WP.52 and the provisions of the current Model Law, are set out below:

"Section [...]. Dynamic purchasing systems

Article [51 undecies]. General provisions

(1) A procuring entity may set up an [electronic] dynamic purchasing system [which shall operate electronically] [for commonly used purchases that are generally available on the market] that shall provide for the procedures, terms and conditions upon which procurement contracts for the supply of goods,

¹ See further A/CN.9/WG.I/WP.44/Add.1, paras. 31-35.

² Directive 2004/18/EC of the European Parliament and of the Council of 31 March 2004 on the coordination of procedures for the award of public works contracts, public supply contracts and public service contracts, available as of the date of this note at http://ec.europa.eu/internal_market/publicprocurement/legislation_en.htm.

³ The Working Group may consider that dynamic purchasing systems are techniques that can be applied in tendering proceedings, rather than a procurement method per se. This consideration applies also to electronic reverse auctions and framework agreements (see A/CN.9/WG.I/WP.51, paras. 3-5, and A/CN.9/WG.I/WP.52, para. 9 and endnote 6).

construction or services may be awarded under the system during a given period.

(2) A dynamic purchasing system shall be set up for a given duration, which is not to exceed [...] years. The duration of the system operation may be extended for no longer than [...] years under exceptional circumstances, upon publication of a notice of the extension of the system in [...] (each enacting State specifies the official gazette or other official publication in which the notice is to be published). The procuring entity shall include in the record required under article 11 of this Law a statement of the grounds and circumstances on which it relied to justify the extension of the duration of the system.

Commentary and issues for discussion in the Guide to Enactment

Paragraph (1)

7. The Working Group may wish to consider elements that may be included in the definition of the dynamic purchasing system in paragraph (1), such as that it is a completely electronic process and suitable for particular types of procurement (the optional text in square brackets would so provide). In this regard, the attention of the Working Group is drawn to the definition of the dynamic purchasing systems provided in the EU Procurement Directive:

“A ‘dynamic purchasing system’ is a completely electronic process for making commonly used purchases, the characteristics of which, as generally available on the market, meet the requirements of the contracting authority, which is limited in duration and open throughout its validity to any economic operator which satisfies the selection criteria and has submitted an indicative tender that complies with the specifications.”

8. The Working Group may also wish to consider the issues raised in paragraph 11 of document A/CN.9/WG.I/WP.52 regarding a possible amendment of the definition of the “procuring entity” in article 2 of the Model Law. In the context of draft article 51 undecies (1) above, that amendment would allow several procuring entities to set up a dynamic purchasing system or use the one set up by a central purchasing entity.

Paragraph (2)

9. The EU Procurement Directive limits the duration of dynamic purchasing systems to four years in normal circumstances (exceptions are permitted with appropriate justification). The Working Group may wish to consider inserting a maximum duration in the text of the Model Law, rather than allowing the procurement regulations or other rules to determine the maximum length. The text also provides that the duration could be extended if it would be desirable to extend the system, rather than setting it up de novo.

10. Unlike the case of extensions of framework agreements (see article 51 octies (4) in document A/CN.9/WG.I/WP.52, the text following paragraph 10), which are closed systems, the notice of an extension of the dynamic purchasing system must be made public (so as to reflect the fact that the system is open to all interested suppliers at any time). Additionally, the procuring entity must justify the extension in the record of the procurement proceedings, and the Guide to Enactment could note that the justification should normally relate to an ongoing need for the

subject-matter of the dynamic purchasing system and lack of significant market changes in the interim.

Article [51 duodecies]. Setting up the dynamic purchasing systems

(1) Where a procuring entity seeks to set up a dynamic purchasing system, the procuring entity shall first publish an invitation to submit indicative tenders in [...] (each enacting State specifies the official gazette or other official publication in which the notice is to be published).

(2) The invitation to submit indicative tenders shall specify, in addition to the information referred to in article 25 (1)(a) and (e) to (i) and article 27 (a) to (c), (i) to (k), (t), (u) and (w) of this Law:

(a) That the procuring entity will set up a dynamic purchasing system;

(b) The nature, estimated quantity and desired place and time of delivery of the purchases envisaged under the dynamic purchasing system;

(c) The terms and conditions of the dynamic purchasing system, including the duration of the dynamic purchasing system, any minimum or maximum number of suppliers or contractors to be admitted to the dynamic purchasing system, the selection criteria and procedure for admittance to the system;

(d) Other necessary information concerning the dynamic purchasing system, the electronic equipment used and the technical connection arrangements;

(e) The [website or other electronic] address at which the specifications, the terms and conditions of the dynamic purchasing system, and other necessary information relevant to the operation of the system may be accessed;

(f) That suppliers or contractors may submit indicative tenders at any time during the period of operation of the dynamic purchasing system, subject to the maximum number of suppliers or contractors to be admitted to the dynamic purchasing system, if any;

(g) Procedures for the award of procurement contracts under the system, including:

(i) Whether an electronic reverse auction will be held and, if so, information required under article [...] of this Law; and

(ii) The criteria to be used by the procuring entity for the evaluation of tenders, including their relative weight and the manner in which they will be applied to that evaluation, and whether the award of a procurement contract will be based on lowest price or lowest evaluated tender.

(3) The procuring entity shall, on publication of the invitation to submit indicative tenders and during the entire period of the operation of the system, ensure unrestricted, direct and full access to the specifications and terms and conditions of the dynamic purchasing system and to any other necessary information relevant to the operation of the system.

(4) The procuring entity shall evaluate all indicative tenders received during the period of operation of the dynamic purchasing system [within a maximum

of [...] days] in accordance with the selection criteria set out in the invitation to submit indicative tenders.

(5) Subject to a maximum number of suppliers or contractors to be admitted to the system and the criteria and procedure for the selection of that number specified in the invitation to submit indicative tenders, the procuring entity shall admit to the system all suppliers or contractors satisfying the selection criteria and having submitted indicative tenders that comply with the specifications and any other additional requirements set out in the invitation to submit indicative tenders.

(6) The procuring entity shall promptly notify the suppliers or contractors of their admittance to the system or of the rejection of their indicative tenders.

(7) Suppliers or contractors that are admitted to the dynamic purchasing system may improve indicative tenders at any time during the period of operation of the dynamic purchasing system, provided that they continue to comply with the specifications set out in the invitation to submit indicative tenders.

(8) The procuring entity shall promptly publish a notice that it has set up a dynamic purchasing system, in any manner that has been specified for the publication of contract awards under article 14 of this Law. The notice shall identify the suppliers or contractors admitted to the system.

Commentary

Paragraph (1)

11. The open nature of the systems requires open solicitation of indicative tenders. Paragraph (1) draws on provisions of article 24 (1).

Paragraph (2)

12. The content of the invitation to submit indicative tenders should include the information referred to in articles 25 (1) and 27. To avoid repetition, appropriate cross-references to the relevant provisions of these articles have been inserted in the paragraph. In addition, the paragraph lists information specific to the systems that have to be made public in the beginning of the procurement proceedings.

13. The wording in the square brackets in subparagraph (e) will be aligned with the similar provisions on electronic reverse auctions (see A/CN.9/WG.I/WP.51, paragraph 29).

14. As in the case of framework agreements, the Working Group may wish to state the transparency and objectivity requirements of evaluation criteria explicitly in this article such as by adding in the appropriate subparagraphs (such as subparagraphs (c) and (g)(ii) the following or similar wording: “the criteria, which, to the extent practicable, shall be objective and quantifiable, and shall be given a relative weight or be expressed in monetary terms wherever practicable” (see, further, A/CN.9/WG.I/WP.52, paragraph 21).

Paragraph (4)

15. The Working Group may wish to consider the timeframe during which indicative tenders should be evaluated and decision on their admittance to the

system or rejection be taken. The equivalent provisions found in the EU Procurement Directive require that evaluation should be completed within a maximum of fifteen days from the date of submission of the indicative tender. However, under that system, the procuring entity may extend the evaluation period provided that no invitation to tender is issued in the meantime.

Article [51 ter decies]. Award of procurement contracts under the dynamic purchasing systems

(1) The procuring entity may subsequently award one or more procurement contracts under the dynamic purchasing system in accordance with the procedures set out in the invitation to submit indicative tenders, subject to the provisions below.

(2) Each specific procurement contract shall be the subject to an invitation to tender.

(3) The procuring entity shall invite all suppliers or contractors admitted to the system to submit tenders for the supply of the items to be procured for each procurement contract it proposes to award. The invitation shall:

(a) Restate, or formulate where necessary more precisely, information referred to in article [51 duodecies (2)(g)] of this Law;

(b) Set out the terms and conditions of the procurement contract, to the extent that are already known to the procuring entity; and

(c) Include instructions for preparing tenders.

(4) The procuring entity shall fix a specific date and time as the deadline for submitting tenders. The deadline shall afford suppliers or contractors sufficient time to prepare and submit their tenders.

(5) The procuring entity shall evaluate all tenders received and determine the successful tender in accordance with the evaluation criteria set out in the invitation to submit tenders under paragraph (3)(a) of this article.

(6) Subject to articles [12, 12 bis and other appropriate references] of this Law, the procuring entity shall accept the successful tender(s), and shall promptly notify the successful supplier(s) or contractor(s) that it has accepted their tender(s). The procuring entity shall also notify all other suppliers and contractors that submitted tenders of the name and address of the supplier(s) or contractor(s) whose tender(s) was or were accepted and the contract price.

(7) The procurement contract, on the terms and conditions of the successful tender(s), comes into force when the notification to the successful supplier or contractor(s) is dispatched.

(8) Where the price payable pursuant to a procurement contract concluded under the provisions of this article exceeds [the enacting State includes a minimum amount [or] the amount set out in the procurement regulations]], the procuring entity shall promptly publish notice of the award of the procurement contract in any manner that has been specified for the publication of contract awards under article 14 of this Law. The procuring entity shall also publish, in the same manner, [quarterly] notices of all procurement contracts issued under the dynamic purchasing system.

Commentary

16. The drafting follows the equivalent provisions for framework agreements, and the Working Group may therefore wish to consider the issues raised in paragraphs 29 and 35 of document A/CN.9/WG.I/WP.52.

Issue of a notice before invitation to tender

17. Under the EU Procurement Directive, when wishing to award procurement contracts under the system, a procuring entity must first publish a simplified contract notice inviting all interested suppliers to submit an indicative tender. The procuring entity may not invite all tenderers admitted to the system to submit a tender until it has completed evaluation of all the indicative tenders received within a fixed time limit after the simplified contract notice was published. Commentators have observed that the transparency advantages of these requirements of the award process may operate as a significant disincentive to their use.⁴

18. If the Working Group considers that provision for a simplified contract notice would be desirable, it could include a paragraph before paragraph (3) in the above text, to provide for example:

“(3) Before inviting suppliers or contractors admitted to the system to submit their tenders, the procuring entity shall:

(a) Publish a simplified notice on the existence of the dynamic purchasing system and inviting all interested suppliers or contractors to consider joining the system by submitting indicative tenders. Article 51 [duodecies (1) and (2)] shall apply to publication of such a simplified notice;

(b) Complete evaluation of all indicative tenders submitted within the timeframe to be fixed in the simplified notice, which may not be less than [...] days from the date of the publication of the simplified notice. Article [51 duodecies (4) to (6)] shall apply to the evaluation of indicative tenders and admittance to the system.”

19. The Working Group may also then wish to consider the timeframe after the publication of the simplified notice within which the procuring entity must allow all interested suppliers or contractors to submit their indicative tenders. This timeframe should be sufficiently long to allow new suppliers to prepare their indicative tenders. The respective provisions of the EU Procurement Directive required that the timeframe should be not less than fifteen days after the simplified notice has been published. This timeframe does not include the additional time that procuring entity may need to complete evaluation of all indicative tenders received by the established deadline (see draft article 51 duodecies (4)).

IV. Consequential changes to provisions of the Model Law

20. Some consequential changes to the existing provisions of the Model Law will be required in the light of the provisions on framework agreements and dynamic purchasing systems. In particular, article 11 on record of procurement proceedings will have to be amended.

⁴ See A/CN.9/WG.I/WP.44/Add.1, para. 35.

21. The Working Group may wish to consider inserting references to framework agreements, where appropriate, in article 11, such as in paragraph (1)(b), (d) and (g) and in paragraph (2). In addition, a new subparagraph (n) may be added in paragraph (1) reading “any other information required to be included in the record of procurement proceedings under provisions of this Law”, which would ensure that such provisions as in articles 51 octies (4) (see A/CN.9/WG.I/WP.52, the text following paragraph 10) and 51 undecies (2) above are covered.

22. This wording would also cover information required to be included in the records of procurement proceedings under other new provisions of the Model Law, such as on electronic reverse auctions. It is to be recalled that, at its tenth session, the Working Group decided to defer its consideration of revisions to article 11 necessitated by the use of electronic reverse auctions.⁵

23. Furthermore, when considering review provisions under Chapter VI of the Model Law, the Working Group may wish to consider whether the use of framework agreements and dynamic purchasing systems as well as their operation should be subject to review.

⁵ A/CN.9/615, para. 65.

III. INTERNATIONAL COMMERCIAL ARBITRATION AND CONCILIATION

A. Report of the Working Group on Arbitration on the work of its forty-fifth session (Vienna, 11-15 September 2006)

(A/CN.9/614) [Original: English]

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I. Introduction

1. At its thirty-first session (New York, 1-12 June 1998), the Commission, with reference to discussions at the special commemorative New York Convention Day held in June 1998 to celebrate the fortieth anniversary of the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York, 1958) (“the New York Convention”), considered that it would be useful to engage in a discussion of possible future work in the area of arbitration. It requested the Secretariat to prepare a note that would serve as a basis for the consideration of the Commission at its next session.¹

2. At its thirty-second session (Vienna, 17 May-4 June 1999), the Commission had before it a note entitled “Possible future work in the area of international

¹ *Official Records of the General Assembly, Fifty-third Session, Supplement No. 17 (A/53/17)*, para. 235.

commercial arbitration” (A/CN.9/460). Welcoming the opportunity to discuss the desirability and feasibility of further development of the law of international commercial arbitration, the Commission generally considered that the time had come to assess the extensive and favourable experience with national enactments of the UNCITRAL Model Law on International Commercial Arbitration (“the Model Law”), as well as the use of the UNCITRAL Arbitration Rules (“the UNCITRAL Arbitration Rules” or “the Rules”) and the UNCITRAL Conciliation Rules, and to evaluate, in the universal forum of the Commission, the acceptability of ideas and proposals for improvement of arbitration laws, rules and practices.² When the Commission discussed that topic, it left open the question of what form its future work might take. It was agreed that decisions on the matter should be taken later as the substance of proposed solutions became clearer. Uniform provisions might, for example, take the form of a legislative text (such as model legislative provisions or a treaty) or a non-legislative text (such as a model contractual rule or a practice guide).³

3. At its thirty-ninth session (New York, 19 June-7 July 2006), the Commission agreed that the topic of revising the UNCITRAL Arbitration Rules should be given priority. The Commission noted that, as one of the early instruments elaborated by UNCITRAL in the field of arbitration, the UNCITRAL Arbitration Rules were recognized as a very successful text, adopted by many arbitration centres and used in many different instances, such as, for example, in investor-State disputes. In recognition of the success and status of the UNCITRAL Arbitration Rules, the Commission was generally of the view that any revision of the UNCITRAL Arbitration Rules should not alter the structure of the text, its spirit, its drafting style, and should respect the flexibility of the text rather than make it more complex. It was suggested that the Working Group should undertake to carefully define the list of topics which might need to be addressed in a revised version of the UNCITRAL Arbitration Rules.⁴

4. The topic of arbitrability was said to be an important question, which should also be given priority. It was said that it would be for the Working Group to consider whether arbitrable matters could be defined in a generic manner, possibly with an illustrative list of such matters, or whether the legislative provision to be prepared in respect of arbitrability should identify the topics that were not arbitrable. It was suggested that studying the question of arbitrability in the context of immovable property, unfair competition and insolvency could provide useful guidance for States. It was cautioned however that the topic of arbitrability was a matter raising questions of public policy, which was notoriously difficult to define in a uniform manner, and that providing a pre-defined list of arbitrable matters could unnecessarily restrict a State’s ability to meet certain public policy concerns that were likely to evolve over time.⁵

5. Other topics mentioned for possible inclusion in the future work of the Working Group included issues raised by online dispute resolution. It was suggested that the UNCITRAL Arbitration Rules, when read in conjunction with other instruments, such as the UNCITRAL Model Law on Electronic Commerce and the United Nations Convention on the Use of Electronic Communications in

² Ibid., *Fifty-fourth Session, Supplement No. 17* (A/54/17), para. 337.

³ Ibid., para. 338.

⁴ Ibid., *Sixty-first Session, Supplement No. 17* (A/61/17), paragraph 184.

⁵ Ibid., para. 185.

International Contracts, already accommodated a number of issues arising in the online context. Another topic was the issue of arbitration in the field of insolvency. Yet another suggestion was made to address the impact of anti-suit injunctions on international arbitration. A further suggestion was made to consider clarifying the notions used in article I, paragraph (1), of the New York Convention of “arbitral awards made in the territory of a State other than the State where the recognition and enforcement of such awards are sought” or “arbitral awards not considered as domestic awards in the State where their recognition and enforcement are sought”, which were said to have raised uncertainty in some State courts. The Commission also heard with interest a statement made on behalf of the International Cotton Advisory Committee suggesting that work could be undertaken by the Commission to promote contract discipline, effectiveness of arbitration agreements and enforcement of awards in that industry.⁶

6. After discussion, the Commission was generally of the view that several matters could be dealt with by the Working Group in parallel. The Commission agreed that the Working Group should resume its work on the question of a revision of the UNCITRAL Arbitration Rules. It was also agreed that the issue of arbitrability was a topic which the Working Group should also consider. As to the issue of online dispute resolution, it was agreed that the Working Group should place the topic on its agenda but at least in an initial phase, should consider the implications of electronic communications in the context of the revision of the UNCITRAL Arbitration Rules.⁷

II. Organization of the session

7. The Working Group, which was composed of all States members of the Commission, held its forty-fifth session in Vienna, from 11 to 15 September 2006. The session was attended by the following States members of the Working Group: Algeria, Argentina, Australia, Austria, Belarus, Brazil, Cameroon, Canada, China, Croatia, Czech Republic, France, Germany, Guatemala, India, Iran (Islamic Republic of), Italy, Japan, Jordan, Kenya, Mexico, Nigeria, Poland, Republic of Korea, Russian Federation, Singapore, Spain, Sweden, Switzerland, Thailand, Tunisia, Turkey, United Kingdom of Great Britain and Northern Ireland, United States of America, and Venezuela (Bolivarian Republic of).

8. The session was attended by observers from the following States: Bahrain, Bulgaria, Democratic Republic of the Congo, Dominican Republic, Finland, Indonesia, Ireland, Kuwait, Latvia, Mauritius, Netherlands, Peru, Philippines, Romania, Slovakia and Ukraine.

9. The session was also attended by observers from the following international intergovernmental organization: Permanent Court of Arbitration.

10. The session was also attended by observers from the following international non-governmental organizations invited by the Working Group: Arab Union for International Arbitration (AUIA), Asia Pacific Regional Arbitration Group (APRAG), *Association Suisse de l'Arbitrage* (ASA), Cairo Regional Centre for International Commercial Arbitration (CRCICA), the Chartered Institute of Arbitrators, the European Law Students Association (ELSA), Forum for

⁶ Ibid., para. 186.

⁷ Ibid., para. 187.

International Commercial Arbitration (FICA), International Arbitration Institute (IAI), International Chamber of Commerce (ICC), International Council for Commercial Arbitration (ICCA), Kuala Lumpur Regional Centre for Arbitration (KLRCA), the London Court of International Arbitration (LCIA), Milan Club of Arbitrators, NAFTA Article 2022 Advisory Committee, School of International Arbitration of the Queen Mary University of London, the Singapore International Arbitration Centre-Construction Industry Arbitration Association (SIAC-CIAA Forum), *Union Internationale des Avocats* (UIA) and the Vienna International Arbitral Centre (VIAC).

11. The Working Group elected the following officers:

Chairman: Mr. Michael Schneider (Switzerland);

Rapporteur: Mr. Triumph Jalichandra (Thailand).

12. The Working Group had before it the following documents: (a) provisional agenda (A/CN.9/WG.II/WP.142); (b) a note by the Secretariat on a revision of the UNCITRAL Arbitration Rules pursuant to the decision made by the Commission at its thirty-ninth session (A/CN.9/WG.II/WP.143 and A/CN.9/WG.II/WP.143/Add.1).

13. The Working Group adopted the following agenda:

1. Opening of the session.
2. Election of officers.
3. Adoption of the agenda.
4. Revision of the UNCITRAL Arbitration Rules and organization of future work.
5. Other business.
6. Adoption of the report.

III. Deliberations and decisions

14. The Working Group commenced its deliberations on agenda item 4 on the basis of the notes prepared by the Secretariat (A/CN.9/WG.II/WP.143 and A/CN.9/WG.II/WP.143/Add.1). The deliberations of the Working Group with respect to this item are reflected in chapter IV. The Secretariat was requested to prepare a first draft of revised UNCITRAL Arbitration Rules, based on the deliberations of the Working Group.

IV. Revision of the UNCITRAL Arbitration Rules

General principles

15. The Working Group recalled the mandate given by the Commission at its thirty-ninth session (New York, 19 June-7 July 2006) and set out above (see above, paras. 3-6) which provided, *inter alia*, that any revision of the UNCITRAL Arbitration Rules should not alter the structure of the text, its spirit and drafting

style and that it should respect the flexibility of the text rather than make it more complex.⁸

16. The Working Group agreed that the UNCITRAL Arbitration Rules had been one of the most successful instruments of UNCITRAL and therefore cautioned against any unnecessary amendments or statements being included in the *travaux préparatoires* that would call into question the legitimacy of prior applications of the Rules in specific cases. It was considered that the focus of the revision should be on updating the Rules to meet changes that had taken place over the last thirty years in arbitral practice.

17. It was pointed out that the UNCITRAL Arbitration Rules were originally intended to be used in a broad range of circumstances and therefore a generic approach was taken in drafting the Rules. The Working Group recalled that, for that reason, the reference to the word “ad hoc” in the title of the UNCITRAL Arbitration Rules had been deleted at the time the Rules were drafted. It was noted that, in practice, there were at least four types of arbitration where the UNCITRAL Arbitration Rules were used, namely; disputes between private commercial parties where no arbitral institution was involved (a type sometimes referred to as “ad hoc” arbitration), investor-State disputes, State-to-State disputes and commercial disputes administered by arbitral institutions. The question was raised whether in revising the UNCITRAL Arbitration Rules, the Working Group should maintain that generic approach or should include provisions, possibly contained in parallel versions or annexes to the UNCITRAL Arbitration Rules, dealing specifically with the different types of arbitration or disputes to which the Rules applied. It was suggested that inclusion of annexes could provide useful guidance for users, such as States and arbitral institutions when adopting the UNCITRAL Arbitration Rules. In that context, the attention of the Working Group was drawn to the Recommendations adopted by UNCITRAL in 1982 to assist arbitral institutions and other interested bodies with regard to arbitrations under the UNCITRAL Arbitration Rules. The Recommendations are designed to provide information and assistance to arbitral institutions and other relevant bodies, such as chambers of commerce, in using the Rules. This may include cases where the Rules are being used as the basis for preparing or revising institutional rules, where arbitral institutions or other bodies are acting as an appointing authority as envisaged under the Rules, or in the provision of administrative services of a secretarial or technical nature for an arbitration conducted pursuant to the Rules.

18. Broad support was expressed for a generic approach that sought to identify common denominators that applied to all types of arbitration irrespective of the subject matter of the dispute, in preference to dealing with specific situations. The Working Group took note that the Rules had been easily adapted to be used in a wide variety of circumstances covering a broad range of disputes and that this quality should be retained. The Working Group further noted that the Rules could apply in the future to other situations or types of disputes that had not yet been identified. The view was expressed that, since practice in various areas, including in investor-State dispute settlement, was still developing, it would be undesirable to seek to design specific provisions at this stage. It was also stated that inclusion of specific provisions could undermine the existing flexibility and simplicity of the Rules and therefore make them less attractive. Others were of the view that, either it

⁸ Ibid., para. 184.

would be desirable to identify provisions which might need a different set of rules for specific purposes or that, at a minimum, that option should not be disregarded.

19. After discussion, the Working Group agreed that the structure and spirit of the UNCITRAL Arbitration Rules should be maintained. Given that some of the discussion would potentially develop useful conclusions relating to specific situations, such as investor-State disputes or institutional arbitration, it was agreed that any such conclusions should be reflected in the *travaux préparatoires* whether or not those conclusions were ultimately reflected in the Rules or in any material that might accompany the Rules.

20. With respect to the working method to be followed at the current session, it was suggested that the Working Group should identify areas where a revision of the UNCITRAL Arbitration Rules might be useful, possibly giving indications as to the substance or principles to be adopted in relation to the proposed revisions, in order to allow the Secretariat to prepare for subsequent sessions the first tentative draft of the revised UNCITRAL Arbitration Rules. The Working Group agreed, on the basis of documents A/CN.9/WG.II/WP.143 and Add.1, to define the list of topics that might need to be addressed in a revised version of the UNCITRAL Arbitration Rules and to hear suggestions to the Secretariat for drafting such revisions but not to reach any conclusion at the current session.

Harmonization of the drafting of the UNCITRAL Arbitration Rules with the Model Law

21. The Working Group agreed that harmonizing the provisions of the UNCITRAL Arbitration Rules with the corresponding provisions of the Model Law should not be automatic but rather considered only where appropriate.

Section I. Introductory rules

Scope of application — Article 1

Applicable version of the UNCITRAL Arbitration Rules

22. It was noted that article 1 dealt with the scope of application of the UNCITRAL Arbitration Rules, without determining which version of the Rules would apply in case of revision. In that respect, it was further noted that the model arbitration clause appended to article 1, paragraph (1) referred to the Rules “as at present in force”.

23. It was observed that a practice in some arbitral institutions was to include an express interpretative provision to the effect that the rules in force on the date of the commencement of the arbitration proceedings (as opposed to the Rules in force on the date of the contract) should apply unless the parties had agreed to the contrary. It was observed that, in practice, some parties had a preference to apply the most up-to-date rules to their dispute whereas others preferred the certainty of agreeing on rules in existence at the time the arbitration agreement was made. It was also said that, inclusion of a provision on the applicable rules would have the benefit of avoiding uncertainty as to the applicable version of the Rules in case of future revisions. That proposal received some support.

24. The Working Group further noted that many investment treaties included a provision on settlement of disputes that referred to the “arbitration rules of the

United Nations Commission on International Trade Law”, without determining which version of those Rules would apply in case of revision.⁹ Some treaties expressly stipulated that, in the event of a revision of the UNCITRAL Arbitration Rules, the applicable version would be the one in force at the time that the arbitration commenced.

25. It was observed that given the contractual nature of the Rules, their binding nature was derived from the will of the parties. No version of the Rules could be considered to be “in force” in and of itself outside the context of an agreement between the parties to the dispute (except possibly where a treaty or other instrument mandated dispute resolution by reference to the Rules). It was cautioned that any provision designating a default version of the Rules should be consistent with the principle of party autonomy. If the parties had agreed to apply the former version of the Rules, any transitional provision should not have any retroactive implications for that agreement.

26. The Working Group agreed to revisit the question of the applicable version of the Rules once it had completed its review of the current text of the UNCITRAL Arbitration Rules. It was pointed out that the decision whether or not to include a default provision on the applicable version might depend upon the overall scale of the modifications.

Paragraph (1)

The writing requirement for the agreement to arbitrate and for modification of the Rules

27. It was questioned whether to retain the requirements in article 1, paragraph (1) that both the agreement of the parties to refer disputes to arbitration under the UNCITRAL Arbitration Rules and any modification thereto should be in writing. Diverging views were expressed on that question.

28. It was noted that the purpose of the requirement that the arbitration agreement be in writing was to set out the scope of application of the UNCITRAL Arbitration Rules and, unlike the function of the form requirement under the Model Law, might be separate from the question of the validity of the arbitration agreement (which was left to the applicable law) or from the question of enforcement under the New York Convention.

29. In support of deletion of the writing requirement, it was said that the question of form was a matter that should be left to the applicable law. It was observed that a number of arbitration rules did not require, as a condition for their applicability, an agreement in writing. It was said that the UNCITRAL Arbitration Rules should, in the interests of harmonization of international arbitration, take a consistent approach with the work of the Working Group in respect of the Model Law, which had reflected a broad and liberal understanding of the form requirement. In addition, it was said that, if such a requirement were to be maintained, it should be defined and that including such a definition would go beyond the usual scope of arbitration rules.

⁹ NAFTA Rules, article 1120 (1)(c); and article 10 (3)(b) of the Greek Model BIT (2001), reprinted in UNCTAD, *International Investment Instruments: A Compendium* vol. VIII (2003) 273; United States of America-Uruguay BIT (2004); article 1(k) of the United States of America Model BIT (1994) reprinted in UNCTAD, *International Investment Instruments: A Compendium* vol. III (1996) 195.

30. However, it was said that preserving a reference to the writing requirement was necessary particularly in light of the fact that there was no uniform approach to that question, some jurisdictions having omitted this requirement and others still requiring writing. In addition, it was noted that the writing requirement could have two functions. First to remind the parties that depending on the applicable law, the agreement to arbitrate might only be valid if made in writing and second, from the point of view of convenience, to provide a basis upon which an appointing authority could appoint arbitrators.

31. The Working Group agreed that that question on whether or not to retain the writing requirement in respect of the arbitration agreement and the modification of the Rules should be further considered.

“disputes in relation to that contract”

32. The Working Group noted that article 1, paragraph (1) referred to disputes “in relation to that contract”. The Working Group considered whether those words should be omitted so as not to suggest any limitation with respect to the types of disputes that parties could submit to arbitration. The Working Group considered whether article 1, paragraph (1) should be widened to include words consistent with article 7 of the Model Law, which permitted arbitration of disputes “in respect of a defined legal relationship, whether contractual or not” or should contain no restriction at all.

33. Some support was expressed for inclusion of the words “in respect of a defined legal relationship, whether contractual or not” for the reason that it encompassed a broad range of disputes, including those arising in investment treaties that did not relate to a contract at all or that related to a contract involving a person that was not a party to the arbitration. It was also said that inclusion of these words would promote consistency between the Rules and the Model Law, which had been adopted widely. However, it was said that these words simply replaced one restriction with another, which unnecessarily limited the scope of the Rules and could raise interpretative questions that would undermine the certainty of the text. It was stated that a preferable approach would be to include no limitation at all.

34. It was noted that, if the words “in relation to that contract” were deleted then, as a matter of consistency, the words “to a contract” appearing after the words “the parties” should also be deleted. It was noted that such deletion could, in the context of disputes arising under investment treaties, create uncertainty given that the parties to the arbitration agreement might be different to the parties to the dispute. In response, it was said that addressing that specific issue in the UNCITRAL Arbitration Rules would add unnecessary complexity. To avoid this complication, a proposal was made to delete any reference to parties in the opening words of article 1, paragraph (1). That suggestion received some support. As a matter of drafting, it was suggested that wordings along the lines of “Where an agreement to arbitrate refers to the UNCITRAL Arbitration Rules (...)” or “Where it has been agreed that a dispute shall be settled by arbitration under the UNCITRAL Arbitration Rules (...)” might require further consideration. The Working Group agreed to revisit that question at a future session.

*Paragraph (2)**International law*

35. The Working Group was generally of the view that it was not necessary to include a reference in article 1, paragraph (2) to “international law” to address cases where a State or an international organization was involved as an arbitrating party. It was said that cases where a source of arbitration law was contained in a treaty or other mandatory international instrument were sufficiently covered by the reference to “the law applicable to the arbitration from which the parties cannot derogate”.

Model arbitration clause

36. A question was raised whether the words “arising out of or relating to this contract” should be deleted from the Model Arbitration Clause. It was recalled that the Working Group had envisaged under article 1, paragraph (1) to delete any reference to a contract (see above, paras. 32-34). In response, broad support was expressed for the retention of the reference to the contract in the Model Arbitration Clause, the purpose of which was precisely to provide a recommendation for the parties wishing to include a clause in their contract. In addition, it was said that the deletion of the words “, or the breach, termination or invalidity thereof”, which would ensue if the words “arising out of or relating to this contract” were deleted, might lead to unintended or negative consequences, depending upon the extent to which the law governing the arbitration agreement recognized the separability of the arbitration agreement.

37. With respect to the contents of the Model Arbitration Clause, several proposals were made to complement the options offered for consideration by the parties in the note placed at the end of the Model Arbitration Clause. One proposal was to add a paragraph along the following lines “(e) the law governing this arbitration agreement shall be (...)”. That concept received broad support, subject to drafting. Another proposal was to add a paragraph referring to the designation of the law governing the contract. That proposal was objected to on the ground that it went beyond the scope of the Arbitration Rules. A further proposal was to amend paragraph (c) to refer to the “[juridical] seat of arbitration” instead of the “place of arbitration” to emphasize that the legal place of the arbitration might differ from the actual place where arbitrators met. Doubts were expressed about that proposal given that it differed from the language used in the Model Law. The Working Group agreed to revisit that proposal in the context of article 16, which dealt with the place of arbitration.

38. A proposal was made to consider whether the arbitration clause should be moved elsewhere given the modifications to article 1, paragraph (1), which no longer contained a reference to a contract. The Working Group agreed to consider that proposal at a future session.

Notice, calculation of periods of time — Article 2*Paragraph (1)**Delivery of the notice*

39. The Working Group noted that article 2, paragraph (1) was based on the 1974 UNCITRAL Convention on the Limitation Period in the International Sale of Goods and set forth default provisions, which the parties could vary. It regulated

in useful detail when a notice, including a notification, communication or proposal could be deemed to have been received. It was noted that a number of existing arbitration rules referred to delivery by electronic means and it was suggested that article 2 should be amended to reflect contemporary practice. It was noted that such amendments would merely constitute a clarification for the avoidance of doubt, and should not be taken to mean that the current version of article 2, paragraph (1) excluded electronic means of communication.

40. It was also noted that article 2, paragraph (1) referred to a “physical delivery” of notices, thus relying on a concept of effective delivery that did not envisage the possibility of deemed delivery. Some considered that the inclusion of a provision on deemed delivery would be helpful, particularly to deal with the situation where delivery was not possible either because a party had absconded or systematically blocked delivery of notices. The Working Group was referred to article 3.3 of the International Chamber of Commerce Arbitration Rules 1998 (“the ICC Rules”) which provided that “A notification or communication shall be deemed to have been made on the day it was received by the party itself or by its representative, or would have been received if made in accordance with the preceding paragraph”, as an example of such a provision.

Paragraph (2)

Modification of periods of time

41. The Working Group proceeded to consider whether article 2, paragraph (2) should be amended to provide that the arbitral tribunal might have an express power to extend or shorten the time periods stipulated under the UNCITRAL Arbitration Rules, as necessary for a fair and efficient process of resolving the parties’ dispute.

42. It was observed that article 2, paragraph (2), which dealt with the method of calculation of time limits, might not be the appropriate place to deal with that more general issue. It was suggested that the power of the arbitral tribunal to modify time limits should be considered under article 15, which provided that the arbitral tribunal could conduct the arbitration in such manner as it considered appropriate. It was suggested that language along the following lines could be included: “In discharge of its duties under article 15, paragraph (1), the arbitral tribunal may at any time extend or abridge any period of time prescribed under or pursuant to the Rules”.

43. Reservations were expressed as to the need for inclusion of an express provision on the power of the arbitral tribunal to extend or abridge stipulated time limits. The view was expressed that that power could be understood as an inherent power of the arbitral tribunal, particularly in light of article 15.

44. A contrary view was expressed that, given that the power in article 15 was stated to be expressly subject to the UNCITRAL Arbitration Rules and that various time periods were stipulated under different articles of the Rules, the Rules could be interpreted as restricting the power of the arbitrator to amend these time periods.

45. It was suggested that the issue could be assessed once the Working Group had examined all provisions that stipulated a time period, and had determined whether expressly establishing the power of the arbitral tribunal to extend or abridge stipulated time periods was appropriate in each context. That proposal received support.

46. It was noted as well that the granting of such power to the arbitral tribunal would be of practical value when the parties failed to agree on applicable time limits. A question was raised whether the arbitrators should nevertheless be granted the power to modify time limits even where the parties had agreed on these matters. A suggestion was made that time limits agreed upon between the parties before the appointment of the arbitral tribunal might be considered as binding on it whereas any such limitation agreed upon by the parties after the arbitral tribunal had been appointed required the approval of the arbitral tribunal. The Working Group agreed to further consider the issue at a future session.

47. A question was raised whether the UNCITRAL Arbitration Rules should include a time limitation for the rendering of the award. The Working Group agreed that that matter should be considered when reviewing article 32 of the Rules (see below, paras. 118-119).

Notice of arbitration — Article 3

Separation of notice of arbitration from statement of claim

48. The Working Group considered whether the notice of arbitration should be separated from the statement of claim. It was stated that the UNCITRAL Arbitration Rules were carefully drafted so as to constitute a compromise between those who wished the statement of claim to be delivered at the outset and those who preferred a two-tiered approach where the notice of arbitration was followed by the statement of claim.

49. The Working Group agreed that the notice of arbitration and the statement of claim should remain separate documents, which might be submitted at different times, for various reasons. First, it was said that it might be impractical for a party to file a statement of claim together with the notice of arbitration in cases where, for example, there was an urgent need to start the arbitral proceedings either due to a limitation period, to the need to seek interim relief, or to precipitate negotiation of a settlement. Second, it was said that permitting the filing of a statement of claim either together or after the notice of arbitration as set out in the current provisions of the UNCITRAL Arbitration Rules provided for the right level of procedural flexibility.

Contents of notice of arbitration

50. A suggestion was made that article 3, paragraphs (3) and (4), which dealt with the contents of the notice of arbitration should be amended to include more detailed or additional information in the interests of improving efficiency of the arbitral procedure.

51. In relation to disputes that did not arise out of or in relation to a contract, a proposal was made to consider whether the notice of arbitration should require an indication of the documents or facts out of or in relation to which the dispute arose. It was said that that approach was too broad and there were other methods to address this issue such as, for example, by including language in subparagraph (d), along the following lines: “A reference to the contract, if any, out of or in relation to which the dispute arises” or “A reference to the contract or other legal instrument out of or in relation to which the dispute arises”.

52. A proposal was made to require for disputes arising out of a contract that the notice of arbitration should include a copy of that contract (rather than merely a

reference to it). It was generally felt that such a requirement would be unnecessarily burdensome and that the existing wording in article 3, paragraph (3)(d) adequately covered all situations, including disputes arising out of a bilateral investment treaty or involving an arrangement, involving some oral part.

53. Another proposal was made to amend article 3, paragraph (3)(e) by replacing the words “general nature” with the words “brief description”. Yet, another proposal was made to add under article 3, paragraph (3) the provisions currently contained in paragraph (4) subparagraphs (a) and (b). A proposal was made to include in the notice of arbitration, in addition to those items already listed in paragraph (3), the following elements: proposals by the claimant with respect to the number of arbitrators, the language and the place of the arbitration, if those matters had not already been agreed upon.

54. It was cautioned that imposing the obligation to include too much information in the notice of arbitration might give rise to the question of how to deal with an incomplete notice of arbitration. The Working Group discussed whether that issue should be addressed in the revised Rules or left to the discretion of the arbitral tribunal. To avoid overloading the notice of arbitration, a suggestion was made to determine whether some of the items proposed for inclusion under paragraph (3) should be included as optional items under paragraph (4). Support was expressed for allowing the arbitral tribunal to determine the consequences of an incomplete notice of arbitration. The Working Group agreed to further consider that issue at a future session.

55. It was observed that the notice of arbitration as currently conceived under the UNCITRAL Arbitration Rules constituted a well-recognized feature of the Rules, allowing the parties to start arbitration proceedings in a timely and efficient manner, and it was said that it would be important not to depart from that feature.

Response to the notice of arbitration

56. The Working Group noted that, since the statement of claim was only an optional element in the notice of arbitration, the arbitral tribunal might be constituted without the respondent having an opportunity (or being required) to state its position with respect to matters such as the jurisdiction, the claim, or any counterclaim.

57. The Working Group considered whether the respondent should be given an opportunity to state its position before the constitution of the arbitral tribunal, by responding to the notice of arbitration, and before the submission by the claimant of its statement of claim. It was suggested that providing such an opportunity or, as proposed by some delegations, a procedural obligation, would have the added advantage of clarifying at an early stage of the procedure the main issues raised by the dispute. It was said that inclusion of a right for the respondent to reply to the notice of arbitration would provide an appropriate balance between the applicant and the respondent. Support was expressed for that proposal. The Working Group agreed to discuss at a future session the possible contents of the response to the notice of arbitration.

Commencement date of arbitral proceedings

58. A question was raised whether the date for commencement of the arbitral proceedings should be the date on which the notice of arbitration had been received by the respondent as provided for under article 3, paragraph (2) or whether

commencement should be delayed until the date on which response to the notice of arbitration had been received. That matter was considered an important question, particularly in States where the arbitration law defined a time limit for the rendering of an award. The view was expressed that the commencement date of the arbitration should be distinguished from the date as of which the time for rendering the award was counted. The Working Group agreed to further consider that issue.

Section II. Composition of the arbitral tribunal

Number of arbitrators — Article 5

59. The Working Group proceeded to consider whether the default rule on the number of arbitrators of three members should be modified. In support of retaining the default composition for arbitral tribunal of three members, it was said that the default rule of three arbitrators was a well-established feature of the UNCITRAL Arbitration Rules, reproduced in the Model Law, ensured a certain level of security by not relying on a single arbitrator, and should in the interests of familiarity be retained.

60. In favour of inclusion of a default rule of a sole arbitrator, it was said that such a rule would render arbitration less costly and thus make it more accessible, particularly to poorer parties and in less complex cases. However, it was questioned whether such parties might prefer the less costly option of a sole arbitrator and it was suggested that arbitral practice indicated that such parties preferred a three member panel which allowed them to choose at least one arbitrator. The Working Group observed that it was normal practice to have one arbitrator as the default rule in arbitrations administered by some institutions with a discretion to appoint three arbitrators, subject to contrary agreement by the parties. It was noted that in arbitrations conducted outside the framework of an arbitral institution, discretionary selection of three arbitrators by the institution would not be available. It was suggested that discretion to intervene could be granted to the appointing authority in non-institutional arbitrations to appoint three arbitrators in more complex arbitrations. However, concern was expressed that such discretion fell outside the traditional role for appointing authorities and could introduce a further level of delay in the arbitral proceedings. As well, at the time of appointment of arbitrators, there might not be an appointing authority. It was said that leaving the question of the number of arbitrators to the appointing authority based on the subjective question of whether or not a case was complex introduced a level of uncertainty.

61. A proposal was made that a better way to address the question of accessibility of arbitration and reduction of cost would be to issue guiding recommendations on how to use the UNCITRAL Arbitration Rules in situations involving small claims.

Appointment of arbitrators — Articles 6 to 8

Multiparty arbitration

62. The Working Group took note that articles 6 to 8, which dealt with the appointment of arbitrators, did not include provisions dealing with appointment of arbitrators in multiparty cases. Support was expressed for inclusion of a two-step procedure for the appointment of arbitrators in a multiparty arbitration such that where there were multiple parties, whether as claimant or as respondent, and where the dispute was to be referred to three arbitrators, the multiple claimants, jointly,

and the multiple respondents, jointly, should nominate an arbitrator. In the absence of such a joint nomination and where all parties were unable to agree on a method for the constitution of the arbitral tribunal, the appointing authority might appoint each member of the arbitral tribunal and designate one of them to act as the presiding arbitrator. Support was expressed for the general principles expressed in that approach.

63. There was general support for the proposal to include a rule which deprived all parties of their right to appoint an arbitrator if the parties on either side were unable to make such an appointment. For example, where the number of either applicants or respondents was very large and did not form a single group with common rights and obligations, involving, for example, a large number of shareholders, the appointing authority should be given authority to make the appointment on their behalf. In the context of that discussion, it was pointed out that the appointing authority should have the discretion to appoint an arbitrator already appointed by a party that was subsequently deprived of its right to appoint. It was suggested that rules relating to multiparty arbitrations should extend beyond appointment of arbitrators and should also deal with the conduct of arbitrations and the method of appointment especially its transparency, where there were multiple parties on both or either side. The Working Group agreed to reconsider these issues at a future session.

Challenge of arbitrators — Articles 9 to 12

Article 9

Ongoing nature of duty to disclose

64. The Working Group proceeded to consider whether article 9, which dealt with the duty of disclosure by an arbitrator, should make it clear that the obligation to disclose matters giving rise to justifiable doubts as to an arbitrator's impartiality and independence was a continuing one, as was provided under article 12, paragraph (1) of the Model Law. It was noted that whilst the Model Law imposed an ongoing obligation by the words "from the time of his appointment and throughout the arbitral proceedings", the Rules merely referred to the duty "once [the arbitrator was] appointed or chosen". The Working Group agreed that the obligation to disclose under the Rules had in practice been interpreted as an ongoing obligation. Nevertheless, it was agreed that, in order to put that matter beyond doubt and in the interests of achieving consistency with the Model Law, the ongoing nature of the duty to disclose be clarified by using similar language to that used in article 12, paragraph (1) of the Model Law.

65. The Working Group did not support a proposal that disclosure should be in the form of a written declaration.

Article 12

Time limits for challenge

66. The Working Group agreed to consider revising article 12 so as to introduce time limits by which the party making a challenge should seek a decision by the appointing authority. The Working Group agreed that other matters, such as whether or not the arbitral proceedings could continue while a challenge was ongoing, should not be addressed, as such matters were dealt with in applicable laws or left to the arbitral tribunal.

Replacement of an arbitrator — Article 13

Resignation of arbitrators

67. The Working Group considered whether the revised version of the UNCITRAL Arbitration Rules should specify conditions for the resignation of arbitrators in order to avoid spurious resignations, or at least minimize their impact on the overall arbitral process. Article 13 did not contain any provision on that question, and it was noted that, in practice, arbitral proceedings had been adversely affected by *mala fide* or tactical resignations of arbitrators.

68. Various options to define conditions under which the resignation of an arbitrator could be permitted were considered by the Working Group. It was noted that in multi-member arbitral tribunals, a resignation could be approved by the other arbitrators. This would require an arbitrator to provide reasons for resigning and to submit to the other arbitrators' scrutiny and judgement, and could act as an effective deterrent against ill-considered or plainly tactical resignations. This practice would be consistent with the general rule that the arbitral tribunal was responsible for the conduct of the proceedings. Another option was to require the appointing authority to approve the resignation of an arbitrator. However, it was said that the other arbitrators would be in a better position to approve or refuse such resignation as they would be aware of the circumstances and facts of the arbitral proceedings.

69. It was questioned whether the Rules should contain criteria for assessing whether the resignation of an arbitrator was made in good faith or not. In that respect, it was noted that arbitral institutions rarely refused the resignation of arbitrators for the practical reason that obliging participation by a reluctant arbitrator would be detrimental to the arbitral process. It was felt as well that setting criteria for the acceptance or refusal of a resignation by an arbitrator might be too rigid, and a preferable approach was to permit either the remaining members of the arbitral tribunal or the appointing authority to determine, by reference to the relevant facts and circumstances whether the resignation was acceptable or not. It was said that that approach had the advantage of respecting the contractual foundation of arbitration.

Consequences of a bad faith resignation

70. It was said that there might be two different ways of dealing with an unapproved resignation of an arbitrator. First, the party having initially appointed the arbitrator might be deprived of the right to appoint a replacement arbitrator, which would be vested instead with the appointing authority. The second was to design a provision on truncated tribunal, which would preserve the existence of a three-person arbitral tribunal and thus satisfy the provision found in some national laws that prohibited even-numbered arbitral tribunals (see below, paras. 73-74).

71. The Working Group considered whether the loss of the right to appoint a substitute arbitrator should be automatic or subject to conditions. It was said that the loss of that right should not be connected with the need to prove collusion with the resigning arbitrator. It was also said that the loss of that right was a serious act, which could only be based on the faulty behaviour of a party to the arbitration. It was said that the loss of that right should be based on a fact-specific inquiry, and should not be subject to defined criteria. Rather, the arbitral tribunal or the appointing authority should determine, in its discretion, whether the party had the right to appoint another arbitrator.

72. It was said that the arbitrator who resigned in bad faith might be held liable for such behaviour under the general rules governing the relationship between the parties and the arbitrator.

Truncated tribunals

73. The Working Group proceeded to consider whether the language used in article 13 precluded the possibility of a “truncated tribunal” whereby, after the resignation of an arbitrator, the remaining arbitrators could continue with the proceedings and possibly issue an award, without a substitute arbitrator being appointed. It was observed that some arbitral tribunals had found that the power to act as a truncated tribunal existed under the present Rules without modification. It was pointed out, however, that there was a risk that an award made by a truncated tribunal might not be recognized under some national laws. The view was also expressed that the inclusion of a provision on truncated tribunals was unnecessary in view of the fact that courts could rule on that point either under article 34 of the Model Law or under article V of the New York Convention. However, it was said that relying on differing court interpretations would create a level of uncertainty in respect of truncated tribunals and that it was desirable to provide a solution during the proceedings rather than leave the issue to be dealt with at the enforcement stage. It was suggested that a provision on replacement of an arbitrator should not be limited to resignation by the arbitrator but could extend to other circumstances such as incapacity or death of the arbitrator.

74. It was stated that including a provision on truncated tribunal would be particularly important if it addressed the circumstances in which the truncated tribunal mechanism would apply. It was agreed that the provision should indicate what kind of conduct would trigger the mechanism, who should be able to decide when the mechanism ought to apply (for example, the appointing authority or the remaining arbitrators), and at what point the mechanism could begin to operate (i.e., only after the conclusion of the hearings or possibly earlier). It was suggested that the mechanism should apply within strict time limits, for example, only once the hearings were closed and should not be available in the case of bona fide resignation but only where there was a *mala fide* resignation or other obstructionist behaviour by an arbitrator.

Repetition of hearings in the event of the replacement of an arbitrator — Article 14

75. The Working Group considered whether article 14 should be revised. Suggestions were made that article 14 be revised to include a provision granting the arbitral tribunal the power to decide whether or not to repeat a hearing when the sole or presiding arbitrator was replaced. Another suggestion was made to revise article 14 along the lines of article 14 of the Swiss Rules of International Arbitration, which provided that, in case of replacement of an arbitrator, the proceedings should resume at the stage where the arbitrator who was replaced had ceased his or her functions, unless the arbitral tribunal decided otherwise. The Working Group requested the Secretariat to provide a revised version of article 14, taking account of the suggested amendments.

Section III. Arbitral proceedings

General provisions — Article 15

76. The Working Group proceeded to consider whether article 15, paragraph (1) should expressly provide that arbitral proceedings should be dealt with by the arbitral tribunal without unnecessary delay. It was said that inclusion of such a principle was otiose but that it might nevertheless be useful to provide leverage for arbitral tribunals to take certain steps both vis-à-vis the other arbitrators and the parties. It was cautioned that inclusion of such a principle could expose the arbitral tribunal to attack for not fulfilling the duty.

77. It was suggested that article 15 of the Rules should not include the words that each party should be given a full opportunity of presenting its case “at any stage of proceedings”, which phrase had been omitted from article 18 of the Model Law. It was suggested that, to avoid a situation where a party would insist on submission at an inappropriate stage of the arbitration, the words “at any stage of proceedings” could be replaced by words such as “at the appropriate stage”. It was also suggested that the reference to the phrase “a full opportunity” could be contentious and that it might be more appropriate to simply refer to “an opportunity”. Caution was expressed as to whether this amendment was really necessary given that the Working Group had no information that the current text had led to problems or created undesirable results.

Preparatory hearings

78. The Working Group agreed that it might not be necessary to include an express provision conferring on the arbitral tribunal the power to hold preliminary consultations or meetings either at the request of the parties or at its own initiative.

Consolidation of cases before arbitral tribunals

79. The Working Group was informed that, in some cases, under the Rules, consolidation of cases was only possible where the parties specifically so agreed and proceeded to consider whether additional provisions on that matter should be added to the Rules. Some support was expressed for inclusion of such provisions based, for example, on the approach taken in article 4 (6) of the ICC Rules, which allowed consolidation when all proceedings related to the same “legal relationship” and subject to the consent of the parties to submit to rules that permitted such consolidation.

80. However, doubts were expressed as to the workability of such a provision given that the Rules often applied in non-administered cases. It was suggested that a number of issues raised by consolidation might be dealt with by other procedures such as set-off or joinder. In that respect, reference was made to article 22.1(h) of the LCIA Arbitration Rules.

Third party intervention in arbitral proceedings

81. The Working Group considered whether an express provision on third party intervention should be included in any revised version of the UNCITRAL Arbitration Rules. It was said that two different situations might be distinguished. One was the situation where a person wished to be heard in the arbitral proceeding,

for example, in the form of *amicus curiae* briefs. The second situation was where a party sought to be joined to the proceedings.

82. It was felt that article 15, paragraph (1), of the UNCITRAL Arbitration Rules, which provided that “the arbitral tribunal may conduct the arbitration in such manner as it considers appropriate”, could be interpreted as including a power of the arbitral tribunal to accept interventions by third parties. It was observed that practice showed that third parties were able to join arbitral proceedings under the UNCITRAL Arbitration Rules and the Working Group agreed that there might not be a need to include an express provision on that matter in a revised version of the UNCITRAL Arbitration Rules.

83. The Working Group agreed that third party intervention in arbitral proceedings was a matter closely connected to the confidentiality of proceedings.

Confidentiality of proceedings

84. The Working Group considered whether an express provision on confidentiality should be included in a revised version of the UNCITRAL Arbitration Rules. It was observed that articles 25, paragraph (4), and 32, paragraph (5), of the UNCITRAL Arbitration Rules dealt with the confidentiality of hearings and awards respectively, but did not contain rules regarding the confidentiality of the proceedings as such, or of the materials (including pleadings) before the arbitral tribunal.

85. The Working Group noted that that matter was quite complex, that there were diverse views expressed on the importance of confidentiality, and that the practice and the law were still evolving. It was said that regulating that issue in too much detail would constitute a major departure from the UNCITRAL Arbitration Rules. It was observed that the scope of confidentiality needed could depend on the subject matter of the dispute and the applicable regulatory regimes.

86. The opinion that a general confidentiality provision should not be included was expressed by many delegations. It was also suggested that the matter should be left to be addressed on a case-by-case basis by the arbitrators and the parties. The Working Group agreed to further discuss whether article 32, paragraph (5) would need to be revised.

Place of arbitration — Article 16

87. The Working Group proceeded to consider whether or not to clarify the term “place of arbitration” in article 16. It was observed that the term “place” was used in article 16 under paragraphs (1) and (4) to refer to the seat of arbitration, which determined the law applicable to the arbitral procedure and court jurisdiction, whereas paragraphs (2) and (3) referred to the physical location where meetings might be held. It was suggested that a review be undertaken of the Rules to distinguish provisions where the reference to the term “place” referred to physical locations from those provisions where it referred to the seat of arbitration.

88. A proposal was made to replace the words “place of arbitration” in article 16, paragraphs (1) and (4) with words such as “the seat of arbitration” or “the juridical seat of arbitration”. Reservations were expressed as to whether the proposed words would in fact improve the understanding of the provision. It was observed that users were often unaware of the legal consequences attached to the term “place of arbitration”. It was suggested that a reference to the “seat of arbitration” could

signal the legal implications of that notion and could differ from the physical place where certain elements of the arbitral procedure were carried out or where an arbitrator might sign the award.

89. The Working Group considered but did not reach a conclusion as to whether the Rules should remain consistent with the Model Law (which currently used the expression “place of arbitration”) or whether a differentiated terminology should be used.

90. A proposal was made to amend paragraph (4), consistent with article 31, paragraph (3) of the Model Law to provide that an award should be deemed to have been made at the place of arbitration to avoid the risk that an award be declared invalid if it was signed in a place other than the seat of arbitration

Language — Article 17

91. The Working Group heard suggestions that it was unnecessary to revise article 17, paragraph (1) so as to expressly require consultation of the arbitral tribunal with the parties to determine the language or languages to be used in the proceedings. Even though it was noted that as drafted, the requirement that the arbitral tribunal “promptly after its appointment, determine the language or languages” could be interpreted as not requiring consultation, the Working Group considered that the Rules did not affect the advisability of consulting the parties before the arbitral tribunal took such or any other procedural decision.

Statement of claim — Article 18

92. The Working Group agreed that it was not necessary to include complementary provisions to article 18 on documentary evidence to be provided by the claimant with its statement of claim. It was agreed that that issue could be left to the discretion of the arbitral tribunal or to the parties in organizing the procedure.

Statement of defence — Article 19

Raising claims for the purpose of set-off

93. Article 19, paragraph (3), of the UNCITRAL Arbitration Rules provided that the respondent might make a counter-claim or rely on a claim for the purpose of a set-off if the claim arose “out of the same contract”. The Working Group considered whether a revised version of the UNCITRAL Arbitration Rules should contain provisions allowing counter-claims or set-off in a wider range of situations.

94. Views were expressed that the arbitral tribunal’s competence to consider counter-claims or set-off should, under certain conditions, extend beyond the contract from which the principal claim arose. To achieve that extension, it was proposed to replace the words “arising out of the same contract” with the words “arising out of the same defined legal relationship”. Another proposal was that the restriction be removed altogether although it was noted that such an approach might render the provision unclear as to the legal basis on which the counter-claim or the set-off would be acceptable.

95. A suggestion was made to provide expressly that an arbitral tribunal could only proceed to deal with a counter-claim or a set-off if it had jurisdiction over those matters. It was recognized that determining that issue raised complex questions of consistency of the Rules with laws governing the issues of jurisdiction,

counter-claim and set-off. The view was expressed that it was preferable not to include in the Rules a specific provision on jurisdictional issues in the context of counter-claims and set-off and that those issues should be left for the arbitral tribunal to decide. Others expressed the view that some provision should clarify the jurisdictional basis for any counter-claim. The Working Group observed that the function of set-off, which could be understood as a form of payment, differed from that of a counter-claim and different legal principles applied to it.

96. As to the range of situations where issues of counter-claim or set-off could be addressed by the arbitral tribunal, the view was expressed that permitting the arbitral tribunal to deal with any such issue arising out of a legal relationship between the parties might raise important issues, especially in the context of investment disputes, where it might be necessary to adopt a particularly broad understanding of the range of counter-claims and set-off that could be dealt with in the same proceedings.

Pleas as to the jurisdiction of the arbitral tribunal — Article 21

Paragraph (1)

97. The Working Group was generally of the view that article 21, paragraph (1) should be redrafted along the lines of article 16, paragraph (1), of the Arbitration Model Law in order to make it clear that the arbitral tribunal had the power to raise and decide upon issues regarding the existence and scope of its own jurisdiction. It was noted that, in cases where both parties participated in the arbitral process, it would be unusual for the arbitral tribunal to raise such issues in the absence of any objections by the parties. However, it was noted that in some cases, for example, where one party did not participate in the proceedings or where complex issues of arbitrability were at stake such as those relating to competition issues, the parties were not necessarily aware of the arbitrability of the subject-matter of the dispute. The arbitral tribunal should therefore be permitted to decide on its own jurisdiction regardless of the position of the parties.

98. The Working Group was also of the view that article 21 of the Rules should contain an equivalent provision to article 16, paragraph (2), of the Arbitration Model Law, which provided that a party was not precluded from raising a plea as to jurisdiction by the fact that it had appointed, or participated in the appointment of, an arbitrator, and that the arbitral tribunal might, in either case, admit a later plea if it considered the delay justified.

Paragraph (4)

99. The Working Group considered whether article 21 should make it clear that recourse to domestic courts should only be made after the arbitral tribunal had pronounced itself on its own jurisdiction, and that such recourse should not delay the arbitral proceedings or prevent the arbitral tribunal from making a further award, in accordance with article 16, paragraph (3), of the Arbitration Model Law.

100. It was observed that such provision might raise legal and practical difficulties. It was noted that a number of national laws provided parties with an irrevocable right to seek recourse from the courts. Constitutional provisions, article 6 of the Convention for the Protection of Human Rights and Fundamental Freedoms adopted by the Council of Europe, and other examples of mandatory legislation were quoted as particularly authoritative sources of law that would take precedence over arbitration rules. In response, it was said that inclusion of a provision limiting

recourse to courts would, pursuant to article 1, paragraph (2) of the Rules, always be subject to mandatory applicable law.

101. It was stated that any proposed provision on recourse should be carefully drafted to take account of the fact that a party should not be prevented from exercising recourse to the courts, particularly before the arbitral tribunal had been constituted and even thereafter if the arbitral tribunal was not functioning properly. For example, where a party sought an application for a stay in a court, that court might need to enquire into the question of jurisdiction.

102. The Working Group agreed to further consider that matter at a future session.

Evidence and hearings — Articles 24 and 25

Article 24

103. The Working Group considered whether a revised version of article 24, paragraph (1) should provide that the power to require a party to produce evidence might be exercised either on the arbitral tribunal's own motion or on the application of any party. The Working Group agreed that that provision did not require modification.

Interim measures of protection — Article 26

104. The Working Group considered whether, and if so, to what extent, article 26 of the UNCITRAL Arbitration Rules should be revised in light of the new Chapter IV A of the Model Law adopted by the Commission at its thirty-ninth session.

105. The Working Group was generally of the view that article 26 should be revised to take account of that new chapter. For instance, the words “in respect of the subject-matter of the dispute”, which were deleted from the equivalent provisions in Chapter IV A, could also be deleted from article 26 for being overly restrictive. A suggestion was made that the revised provisions on interim measures might clarify the circumstances, conditions and procedure for the granting of interim measures, consistent with Chapter IV A, or be drafted in such a way that they would give effect to the party autonomy provided by Chapter IV A. However, the Working Group agreed that, given the nature of the Rules, a number of provisions contained in Chapter IV A should not be replicated, such as provisions on the enforcement of interim measures. The view was expressed that the provisions of Chapter IV A that were of a contentious nature and had previously given rise to diverging views in the Working Group should not be included in the UNCITRAL Arbitration Rules, in order not to endanger their wide acceptability.

Experts — Article 27

106. The Working Group considered whether a revised version of the UNCITRAL Arbitration Rules should refer to consultation with the parties before appointing any expert. While the view was expressed that such an obligation was implied, the contrary view was also held that the Rules created no obligation for the arbitral tribunal to consult with the parties in that case. In addition, it was said that the inclusion of such an express statement might lead to unintended results in that it could be misinterpreted as excluding the possibility that the parties be consulted on other matters such as, for example, the content of the report produced by the expert.

107. The Working Group considered whether article 27 should provide that an arbitral tribunal be given the power to direct any expert presented by the parties to meet with the expert appointed by the arbitral tribunal in order to attempt to reach an agreement on contentious issues or, at least, to narrow them down. That proposal was not supported. After discussion, the Working Group was generally of the view that article 27 should remain unaltered.

Section IV. The award

Decisions — Article 31

Paragraph (1)

108. It was noted that article 31, paragraph (1) required that an award be made by a majority of arbitrators in cases where there was a three-member arbitral tribunal. It was proposed to revise that paragraph in order to avoid a deadlock situation where no majority decision could be made. It was said that one solution could be to revise paragraph (1) so as to provide that if an arbitral tribunal composed of three arbitrators could not reach a majority, then the award would be decided by the presiding arbitrator as if he or she were a sole arbitrator.

109. It was said that in the absence of such a provision, the presiding arbitrator could be forced to compromise his or her views to join with the least unreasonable of the co-arbitrators in order to form a majority. However, fears were expressed that such a provision would give too much power to presiding arbitrators. In addition, it was noted that, in cases administered under rules that conferred upon presiding arbitrators the right to make a casting vote, practice had shown that presiding arbitrators rarely exercised that right, as they preferred to seek a unanimous award for the reason that it was felt to have greater persuasion. In response, it was stated that if that right rarely had to be used, it was because it created conditions under which members of arbitral tribunals sought to find common grounds with presiding arbitrators.

110. If such a rule was considered appropriate, it was suggested that consequential amendments relating to the signing of the award and truncated tribunals might also need to be considered.

111. Reservations were expressed as to the need for the proposed rule. It was suggested that the requirement for a majority decision was a well-known feature not only of the UNCITRAL Arbitration Rules but also of other successful sets of rules, such as the arbitration rules of the American Arbitration Association.

112. Given the differing views expressed, the Working Group requested the Secretariat to prepare various options for consideration by the Working Group at a future session, based on information regarding the existing practice of arbitration institutions on that issue.

Form and effect of the award — Article 32

Paragraph (1)

113. It was suggested that the word “partial”, which was not used in the Model Law, should be deleted given that a partial award could be considered a final award in respect of the issues on which it ruled.

Paragraph (2)

114. It was proposed that the revised Rules should include a provision inspired from article 28, paragraph (6), of the ICC Rules and article 26.9 of the LCIA Rules, whereby the award should be subject to no appeal or other recourse before any court or other authority. The effect of the new provision would be to make it impossible for parties to use those types of recourse that could be freely waived by the parties (for example, in some jurisdictions, an appeal on a point of law), but not to exclude challenges to the award (for example, on matters such as lack of jurisdiction, violation of due process or any other ground for setting aside the award as set out under article 34 of the Model Law), inasmuch as the parties could not exclude them by contract.

Paragraph (5)

115. A suggestion was made that the rule contained in paragraph (5) could be reversed requiring an award to be published unless parties agreed otherwise. It was further proposed that any revision of paragraph (5) take account of cases where a party was under a legal duty to disclose an award or its tenor.

116. A question was raised whether paragraph (5) should also encompass draft awards. It was noted that inclusion of draft awards could have implications on confidentiality of deliberations, which the Working Group agreed was a separate issue, yet unsettled in practice, which needed to be further considered.

Paragraph (7)

117. A suggestion was made to revise paragraph (7) so as to avoid an onerous burden being placed on an arbitral tribunal in countries where registration requirements were ambiguous. It was suggested that a revised draft be prepared providing that compliance of the arbitral tribunal with registration requirements be made subject to a timely request of any party. However, reservations were expressed that such a revision might not relieve arbitrators of a registration duty under applicable law and the Secretariat was requested to examine the nature of such duty.

Time limit for rendering the award

118. The Working Group considered whether a time limit should be imposed for rendering of an award. It was noted that the existence of time limits was well known in institutional rules and that, in practice, extensions of such time limits were systematically given. Some support was expressed for inclusion of a time limit with the arbitral tribunal having a one-time option to extend that period.

119. Reservations were expressed on that proposal given that, in non-administered arbitrations, there would be no institution to deal with possible extensions of the time limit. As well, it was indicated that in States having time limits in their arbitration laws, practical problems also existed and therefore strong opposition was expressed to a time limit. It was suggested that rather than imposing an arbitrary time period, flexibility should be retained by inclusion of a general principle that there not be undue delay in rendering an award.

Possible new paragraph (8)

120. The Working Group considered whether a provision imposing a duty on arbitrators and parties to act in the spirit of the UNCITRAL Arbitration Rules, even

in circumstances where no specific provision covered the situation in question, should be added. In that respect, it was said that inclusion of principles contained in articles 15 and 35 of the ICC Rules or in article 32 of the LCIA Rules should be considered. The attention of the Working Group was brought to the need of formulating the new rule in such a way that it would avoid vagueness. After discussion, a provision of the kind suggested was broadly supported, to the extent it would clarify that the Rules constituted a self-contained system of contractual norms and that any lacuna therein was to be filled by interpreting the Rules themselves, without reference to any non-mandatory provision of applicable procedural law.

121. It was also proposed to include a provision on the interpretation of the Rules in accordance with their international origin in line with the new article 2 A of the Model Law.

Applicable law, amiable compositeur — Article 33

Paragraph (1)

Law applicable to the substance of the dispute

122. The Working Group considered whether the words “rules of law” currently used in article 28 of the Model Law should also be used in a revised version of article 33 of the UNCITRAL Arbitration Rules to replace the term “law”. Diverging views were expressed on that point and the Secretariat was requested to prepare alternative drafts for consideration by the Working Group at a future session.

123. Another proposal was made to replace the default provision that reference be made to conflict of laws rules failing designation by the parties with a reference to a direct choice of the rules of law most closely connected to the dispute.

Paragraph (2)

Ex aequo et bono — Amiable compositeur

124. The Working Group considered whether article 33, paragraph (2) should be modified to delete the requirement that the law applicable to the arbitral procedure permit an arbitration to be decided *ex aequo et bono*. No support was expressed for that modification.

Interpretation of the award — Article 35

125. A proposal was made that the request to the arbitral tribunal to give an interpretation of the award should be made by both parties. That proposal did not receive support.

126. The Working Group considered whether article 35 should only apply where there was a need to interpret what the award ordered the parties to do. That proposal did not receive support.

Correction of the award — Article 36

127. The Working Group considered whether the scope of article 36 should be broadened to include correction of the award in situations such as arbitrator having omitted to sign the award or to state the date or place of the award. Diverging views were expressed. It was said that the text, which allowed correction in the award of

“any errors in computation, any clerical or typographical errors, or any errors of similar nature” was sufficiently broad to encompass such matters. To clarify that omissions were included, a proposal was made to add the words “or omission”.

Additional award — Article 37

128. The Working Group considered whether the words “without any further hearings or evidence” should be deleted on the basis that arbitrators should be free to convene hearings or request further evidence or pleadings. Support was expressed for that proposal as it allowed the arbitral tribunal to complete the award in respect of claims that were presented during the arbitral proceedings but had been overlooked in the award. It was suggested that, if further hearings or evidence were necessary, the sixty-day period contained in paragraph (2) might not apply. Reservations were expressed with respect to recognizing the possibility for the arbitral tribunal to hold hearings or receive further evidence, which could be used by the parties as a dilatory tactic to reopen arbitral proceedings.

129. Diverging interpretations were expressed as to whether paragraph (2) could be understood as already allowing the arbitral tribunal to make an additional award after holding further hearings and taking further evidence.

Costs — Articles 38 to 40

Article 38

130. The Working Group considered whether the list of elements included in article 38 was exhaustive. It was stated that the word “only” used in the chapeau resulted in the list being exhaustive.

131. No support was expressed in favour of a proposal to add a reference to the fees and expense of a secretary in paragraph (c). It was said that such fees and expenses were already covered in paragraph (c) through use of the words “other assistance required by the arbitral tribunal”.

132. The view was expressed that paragraphs (b)-(d) should be qualified by the word “reasonable”.

Article 39

133. The Working Group considered whether it was necessary to provide more guidance on the question of the fees of the arbitrators in any revision of the UNCITRAL Arbitration Rules. It was noted that the absence of any provision on fees could create reluctance to choose the UNCITRAL Arbitration Rules.

134. It was suggested that consideration be given to granting a role to the appointing authority in respect of fees. Some reservations were expressed to granting such a role to appointing authorities for the reason that it might extend beyond their experience. However, it was noted that a number of appointing authorities had experience regarding the functioning of arbitration, including the setting of costs. Another option proposed was to provide a more transparent procedure for agreeing on the method of calculating the arbitral tribunal’s fees from the outset.

Article 40

135. A view was expressed that the costs of legal representation and assistance referred to under article 40, paragraph (2) might be already included in the costs of arbitration referred to under article 40, paragraph (1), and that therefore either the two paragraphs should be merged or the distinction between the two categories of costs should be clarified in any proposed revision of that article.

Additional provision**Liability of arbitrators**

136. The Working Group noted that the question of liability had given rise to case law and that a provision on that matter, whether limiting or excluding liability of arbitrators, should be considered for inclusion in the UNCITRAL Arbitration Rules. It was suggested that any provision on liability could require accompanying provisions setting out a code of ethics for arbitrators.

**B. Note by the Secretariat on settlement of commercial disputes:
Revision of the UNCITRAL Arbitration Rules, submitted to the
Working Group on Arbitration at its forty-fifth session
(A/CN.9/WG.II/WP.143 and Add.1) [Original: English]**

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Introduction

1. At its thirty-ninth session (New York, 19 June-7 July 2006), the Commission agreed that, in respect of future work of the Working Group, priority be given to a revision of the UNCITRAL Arbitration Rules (1976) ("the UNCITRAL Rules").¹ The Commission previously discussed that matter at its thirty-sixth (Vienna, 30 June-11 July 2003), thirty-seventh (New York, 14-25 June 2004) and thirty-eighth sessions (Vienna, 4-15 July 2005).²

2. At the forty-fourth session of the Working Group (New York, 23-27 January 2006), in order to facilitate a review of the UNCITRAL Rules, it was proposed to undertake preliminary consultations with practitioners to develop a list of potential topics on which updating or revision might be necessary.³ A conference was held in Vienna on 6 and 7 April 2006 in cooperation with the International Arbitral Centre of the Austrian Federal Economic Chamber. Suggestions were made to amend a number of articles of the UNCITRAL Rules in order to better align the Rules with

¹ *Official Records of the General Assembly, Sixty-first Session, Supplement No. 17 (A/61/17)*, paras. 182-187.

² *Ibid.*, *Fifty-eighth Session, Supplement No. 17 (A/58/17)*, para. 204; *ibid.*, *Fifty-ninth Session, Supplement No. 17 (A/59/17)*, para. 60; *ibid.*, *Sixtieth Session, Supplement No. 17 (A/60/17)*, para. 178.

³ A/CN.9/592, paras. 90 and 93.

current international arbitration practice and the relevant provisions of the UNCITRAL Model Law on International Commercial Arbitration (“the Arbitration Model Law”).

3. To facilitate discussions of the Working Group on that topic, the Secretariat has prepared an annotated list of possible areas of revision of the UNCITRAL Rules, as suggested by arbitration experts during that conference, and as detailed in writings of such experts.⁴ This note covers articles 1 to 16 of the UNCITRAL Rules. Articles 17 to 41 are dealt with under A/CN.9/WG.II/WP.143/Add.1. This note and the addendum identifies areas of consensus as well as possible trends in modern arbitration and how those trends are reflected in arbitration rules with a view to extracting therefrom possible areas for revision of the UNCITRAL Rules. The annotated list is not intended to be exhaustive, and the Working Group might wish to raise additional issues.

4. It is suggested that the forty-fifth session of the Working Group be devoted to identifying areas where revisions of the UNCITRAL Rules might be useful, possibly giving indications as to the substance or principles to be adopted in relation to the proposed revisions, in order to allow the Secretariat to prepare for subsequent sessions the first tentative draft of revised UNCITRAL Rules.

Notes on a revision of the UNCITRAL Arbitration Rules

1. General remarks

Principles to be applied in revising the UNCITRAL Rules

5. At the thirty-ninth session of the Commission (New York, 19 June-7 July 2006), in recognition of the success and status of the UNCITRAL Rules, the Commission was generally of the view that any revision of the UNCITRAL Rules should not alter the structure of the text, its spirit, its drafting style, and should respect the flexibility of the text rather than make it more complex. It was suggested that the Working Group should undertake to carefully consider the list of topics which might need to be addressed in a revised version of the UNCITRAL Rules.

Harmonization of the drafting of the UNCITRAL Rules with the Arbitration Model Law

6. The Working Group might wish to consider harmonizing the provisions of the UNCITRAL Rules with the corresponding provisions of the Arbitration Model Law, where appropriate.⁵

⁴ *The work of UNCITRAL on Arbitration and Conciliation*, by Prof. Pieter Sanders, Second and Expanded Edition, Kluwer Law International; *Has the moment come to revise the Arbitration Rules of UNCITRAL?* by Prof. Pieter Sanders, *Arbitration International*, Vol. 20, No. 3, 2004. Unpublished and informal report: *Revision of the UNCITRAL Arbitration Rules*, by Jan Paulsson and Georgios Petrochilos, prepared for the UNCITRAL Secretariat.

⁵ For instance, the following articles of the UNCITRAL Rules might be aligned, to the extent relevant, with corresponding provisions of the Arbitration Model Law: article 2, paragraph (1), of the UNCITRAL Rules with article 3, paragraph (1), of the Arbitration Model Law; article 9 of the UNCITRAL Rules with article 12 of the Arbitration Model Law; article 13 of the UNCITRAL Rules with article 14 of the Arbitration Model Law; article 15 of the UNCITRAL Rules with article 24 of the Arbitration Model Law; article 16 of the UNCITRAL Rules with article 20 of the Arbitration Model Law; article 21 of the Arbitration Rules with article 16 of the

2. Notes on the provisions of the UNCITRAL Rules

7. Only articles on which substantive revisions are discussed are referred to below. The text of articles quoted in this note in *italic* is the original text of the UNCITRAL Rules.

Section I. Introductory rules

Scope of application — Article 1

“1. Where the parties to a contract have agreed in writing that disputes in relation to that contract shall be referred to arbitration under the UNCITRAL Arbitration Rules, then such disputes shall be settled in accordance with these Rules subject to such modification as the parties may agree in writing.*

“2. These Rules shall govern the arbitration except that where any of these Rules is in conflict with a provision of the law applicable to the arbitration from which the parties cannot derogate, that provision shall prevail.”

**Model Arbitration Clause*

Any dispute, controversy or claim arising out of or relating to this contract, or the breach, termination or invalidity thereof, shall be settled by arbitration in accordance with the UNCITRAL Arbitration Rules as at present in force.

Note — Parties may wish to consider adding:

(a) The appointing authority shall be ... (name of institution or person); (b) The number of arbitrators shall be ... (one or three); (c) The place of arbitration shall be ... (town or country); (d) The language(s) to be used in the arbitral proceedings shall be ...

Applicable version of the UNCITRAL Rules

8. Article 1 deals with the scope of application of the UNCITRAL Rules, without determining which version of the Rules would apply in case of revision. In that respect, it might be noted that the model arbitration clause appended to article 1, paragraph (1) refers to the Rules “as at present in force”.

9. The Working Group might wish to note that many investment treaties include a provision on settlement of disputes which refers to the “arbitration rules of the United Nations Commission on International Trade Law”, without determining which version of those Rules would apply in case of revision.⁶ Some treaties expressly stipulate that, in the event of a revision of the UNCITRAL Rules, the

Arbitration Model Law; article 28 of the UNCITRAL Rules with article 25 of the Arbitration Model Law; article 31 of the UNCITRAL Rules with article 29 of the Arbitration Model Law; article 33 of the UNCITRAL Rules with article 28 of the Arbitration Model Law; article 34 of the UNCITRAL Rules with article 32 of the Arbitration Model Law; article 37 of the UNCITRAL Rules with article 33 of the Arbitration Model Law.

⁶ NAFTA Rules, article 1120 (1) (c); and article 10 (3) (b) of the Greek Model BIT (2001), reprinted in UNCTAD, *International Investment Instruments: A Compendium* vol. VIII (2003) 273; United States of America-Uruguay BIT (2004); article 1 (k) of the United States of America Model BIT (1994) reprinted in UNCTAD, *International Investment Instruments: A Compendium* vol. III (1996) 195.

applicable version will be the one in force at the time that the arbitration is commenced.⁷

10. The rules of several arbitration centres contain a clarification on the applicable version of the rules in case of revision. For instance, the International Chamber of Commerce Arbitration Rules (“ICC Rules”) contain an express interpretative provision to the effect that the parties “shall be deemed to have submitted ipso facto to the Rules in effect on the date of the commencement of the arbitration proceedings, unless they have agreed to submit to the Rules in effect on the date of their arbitration agreement” (article 6, paragraph (1)). The Arbitration Rules of the London Court of International Arbitration (“the LCIA Rules”) contain in their preamble a statement clarifying that the applicable Rules are the current version of the Rules (“the following Rules”) or, in case of a revision, “such amended rules as the LCIA may have adopted hereafter to take effect before the commencement of the arbitration”.

11. The Working Group might wish to consider whether to revise article 1, by providing as a default rule that the most recent version of the UNCITRAL Rules apply, subject to contrary agreement of the parties.

Paragraph (1)

The writing requirement for the agreement to arbitrate

12. Article 1, paragraph (1) requires that the agreement of the parties to refer disputes to arbitration under the UNCITRAL Rules be in writing.

13. The *travaux préparatoires* indicate that the purpose of the requirement that the arbitration agreement be in writing was to avoid uncertainty as to whether the UNCITRAL Rules have been made applicable. That requirement was also intended to ensure conformity with article II, paragraph (2), of the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York, 1958) (“the New York Convention”).⁸

14. It might be noted that there has been constant development of international arbitral practice on this question.

15. The Working Group might wish to note that the revised version of article 7 of the Arbitration Model Law on the definition and form of the arbitration agreement, as adopted by the Commission at its thirty-ninth session (New York, 19 June–7 July 2006), contains two options, the first one including a liberalized definition of the writing requirement, and the second deleting altogether that requirement. At that session, the Commission adopted a Recommendation on the interpretation of article II, paragraph (2), of the New York Convention, recommending “that

⁷ Hong Kong SAR-Italy BIT (1995); United Kingdom of Great Britain and Northern Ireland-Bosnia and Herzegovina BIT (2002); article 8 (2) (c) of the United Kingdom Model BIT (1991) reprinted in UNCTAD, *International Investment Instruments: A Compendium* vol. III (1996) 185.

⁸ Report of the Secretary-General: revised draft set of arbitration rules for optional use in ad hoc arbitration relating to international trade (UNCITRAL Arbitration Rules) (addendum): commentary on the draft UNCITRAL Arbitration Rules (A/CN.9/112/Add.1), Section I, Commentary on article 1, UNCITRAL Yearbook, Volume VII: 1976, Part Two, III, 2.

article II, paragraph (2) be applied recognizing that the circumstances described therein are not exhaustive”.⁹

16. The arbitration rules of several institutions do not require, as a condition for their applicability, an agreement in writing. For instance, the ICC Rules only require that the parties have agreed to submit to arbitration under the ICC Rules. The Swiss Rules of International Arbitration (“the Swiss Rules”), which are based on the UNCITRAL Rules, provides that “these Rules shall govern international arbitrations, where an agreement to arbitrate refers to these Rules (...)” (article 1, paragraph (1)). As well, the rules of the Arbitration Institute of the Stockholm Chamber of Commerce (“SCC Rules”) do not require any written arbitration agreement.

17. Other institutions, which still maintain the writing requirement, seek to adopt a flexible definition of that requirement. For instance, the preamble of the LCIA Rules states that: “where an agreement (...) provides in writing and in whatsoever manner for arbitration under the Rules of the LCIA (...), the parties shall be taken to have agreed in writing that the arbitration shall be conducted in accordance with the following rules (...)”.

18. The Working Group might wish to consider whether the writing requirement should be retained.

The writing requirement for modification of the Rules

19. Article 1, paragraph (1) requires that the parties set out any modification they wish to make to the UNCITRAL Rules in writing.

20. According to the *travaux préparatoires*, the requirement that modification to the UNCITRAL Rules be in writing was intended to create certainty as to the ambit of such a modification.¹⁰

21. It might be noted that certain arbitration rules provide for a similar obligation. For instance, the preamble of the Arbitration Rules of the Singapore International Arbitration Centre (“the SIAC Rules”) states that “where any agreement, submission or reference provides for arbitration under the (...) Rules, the parties thereto shall be taken to have agreed that the arbitration shall be conducted in accordance with the following Rules (...), subject to such modifications as the parties may agree in writing”.

22. For instance, the Swiss Rules, the LCIA Rules, or the SCC Rules do not contain an obligation that modification by the parties to the Rules be in writing.

23. The Working Group might wish to consider whether the writing requirement should apply in respect of modifications.

⁹ *Official Records of the General Assembly, Sixty-first Session, Supplement No. 17 (A/61/17)*, Annex II.

¹⁰ Report of the Secretary-General: revised draft set of arbitration rules for optional use in ad hoc arbitration relating to international trade (UNCITRAL Arbitration Rules) (addendum): commentary on the draft UNCITRAL Arbitration Rules (A/CN.9/112/Add.1), Section I, Commentary on article 2, UNCITRAL Yearbook, Volume VII: 1976, Part Two, III, 2.

“disputes in relation to that contract”

24. Article 1, paragraph (1) refers to disputes in relation to a contract. The Working Group might wish to consider whether the ambit of the UNCITRAL Rules should include such a limitation, or be widened and include words consistent with article 7 of the Arbitration Model Law, which permits arbitration of disputes “in respect of a defined legal relationship, whether contractual or not”.¹¹

25. It might be noted that other sets of arbitration rules (such as the ICC Rules and the LCIA Rules) do not contain such limitation.

Paragraph (2)

International law

26. The Working Group might wish to consider whether article 1, paragraph (2) should include an explicit reference to “international law” to better deal with cases where a State or an international organization is involved as an arbitrating party.

Notice, calculation of periods of time — Article 2

“1. For the purposes of these Rules, any notice, including a notification, communication or proposal, is deemed to have been received if it is physically delivered to the addressee or if it is delivered at his habitual residence, place of business or mailing address, or, if none of these can be found after making reasonable inquiry, then at the addressee’s last-known residence or place of business. Notice shall be deemed to have been received on the day it is so delivered.

“2. For the purposes of calculating a period of time under these Rules, such period shall begin to run on the day following the day when a notice, notification, communication or proposal is received. If the last day of such period is an official holiday or a non-business day at the residence or place of business of the addressee, the period is extended until the first business day which follows. Official holidays or non-business days occurring during the running of the period of time are included in calculating the period.”

Paragraph (1)

27. Article 2, paragraph (1) is based on the 1974 UNCITRAL Convention on the Limitation Period in the International Sale of Goods and set forth default provisions, which the parties may vary. It regulates in useful detail when a notice, including a notification, communication or proposal is deemed to have been received. It includes a reference to a physical delivery of notices, which represents the “concept of effective delivery” as strongly supported in the *travaux préparatoires*.¹²

¹¹ Options 1 and 2 of article 7 of the Arbitration Model Law, as adopted by the Commission at its thirty-ninth session: *Official Records of the General Assembly, Sixty-first Session, Supplement No. 17 (A/61/17)*, Annex I; the same phrase was contained in the 1985 version of article 7 of the Arbitration Model Law.

¹² Report of the Secretary-General: revised draft set of arbitration rules for optional use in ad hoc arbitration relating to international trade (UNCITRAL Arbitration Rules) (addendum): commentary on the draft UNCITRAL Arbitration Rules (A/CN.9/112/Add.1), Section I, Commentary on article 3, UNCITRAL Yearbook, Volume VII: 1976, Part Two, III, 2.

28. It might be noted that the Arbitration Rules of the American Arbitration Association (“AAA Rules”) provide that “(...) all notices, statements and written communications may be served on a party by air mail, air courier, facsimile, transmission, telex, telegram or other written form of electronic communication addressed to the party or its representative at its last known address or by personal service” (article 18, paragraph (1)). The ICC Rules provide that all notifications or communications shall be made “by delivery against receipt, registered post, courier, facsimile transmission, telex, telegram or any other means of telecommunication that provides a record of the sending thereof” (article 3, paragraph (2)). The LCIA Rules contain a similar provision (article 4.1).

29. The Working Group might wish to consider whether that provision, which might be read as excluding electronic communications, should be amended to reflect contemporary practice.

Paragraph (2)

30. The Working Group might wish to consider whether paragraph (2) should provide that the arbitral tribunal might have an express power to extend or shorten the time-periods stipulated under the UNCITRAL Rules, as necessary for a fair and efficient process of resolving the parties’ dispute. The granting of such power to the arbitral tribunal would be of practical value when the parties fail to agree on these matters.

31. Example of such provisions might be found in the LCIA Rules, which provide that “The arbitral tribunal may at any time extend (even where the period of time has expired) or abridge any period of time prescribed under these Rules or under the Arbitration Agreement for the conduct of the arbitration, including any notice or communication to be served by one party on any other party” (article 4.7). The Rules of Arbitration of the World Intellectual Property Organization (“the WIPO Rules”) provide that “The tribunal shall ensure that the arbitral procedure takes place with due expedition. It may, at the request of a party or on its own motion, extend in exceptional cases a period of time fixed by these Rules, by itself or agreed to by the parties. In urgent cases, such an extension may be granted by the presiding arbitrator alone” (article 38 (c)).

Notice of arbitration — Article 3

“1. The party initiating recourse to arbitration (hereinafter called the “claimant”) shall give to the other party (hereinafter called the “respondent”) a notice of arbitration.

“2. Arbitral proceedings shall be deemed to commence on the date on which the notice of arbitration is received by the respondent.

“3. The notice of arbitration shall include the following:

“(a) A demand that the dispute be referred to arbitration;

“(b) The names and addresses of the parties;

“(c) A reference to the arbitration clause or the separate arbitration agreement that is invoked;

“(d) A reference to the contract out of or in relation to which the dispute arises;

“(e) The general nature of the claim and an indication of the amount involved, if any;

“(f) The relief or remedy sought;

“(g) A proposal as to the number of arbitrators (i.e. one or three), if the parties have not previously agreed thereon.

“4. The notice of arbitration may also include:

“(a) The proposals for the appointments of a sole arbitrator and an appointing authority referred to in article 6, paragraph 1;

“(b) The notification of the appointment of an arbitrator referred to in article 7;

“(c) The statement of claim referred to in article 18.”

32. During the discussions on the preparation of the UNCITRAL Rules, the *travaux préparatoires* indicate that the Commission heard the views that article 3 constitutes a “bridge between the civil and common law systems” and a “reasonable compromise” between those who wished the statement of claim to be delivered at the outset and those who preferred a two-tier approach where the notice of arbitration is followed by the statement of claim.¹³

Notice of arbitration separated from statement of claim

33. Paragraph (3) requires the claimant’s notice of arbitration to indicate the “general nature” of its claim (paragraph (3) (e)) as well as the “remedy or relief sought” (paragraph (3) (f)). As the statement of claim is only an optional element in the notice of arbitration, the arbitral tribunal might be constituted without the respondent having an opportunity (or being required) to state its position with respect to (i) jurisdiction, (ii) the claim, or (iii) any counterclaim. Article 18 of the UNCITRAL Rules sets out the requirements for a statement of claim if it was not included in the notice of arbitration.

34. In that respect, the Working Group may wish to note that the Swiss Rules include the statement of claim as an optional element of the notice of arbitration (article 3, paragraph (4)). By contrast, the AAA Rules require that the notice of arbitration “shall contain a statement of claim” (article 2, paragraph (3)). The ICC Rules provide that the request for arbitration contain, inter alia, “a description of the nature and circumstances of the dispute giving rise to the claim(s);” (...) “a statement of relief sought, including, to the extent possible, any indication of the amount(s) claimed” (article 4, paragraph (3)). The LCIA Rules provide that the claimant’s written request for arbitration should be accompanied by “a description of the nature and circumstances of the dispute and the specification of the claim” (article 1.1 (c)) as well as “a statement of any matters (...) on which the parties have already agreed in writing for the arbitration or in respect of which the claimant wishes to make a proposal” (article 1.1 (d)). The SCC Rules require that the request for arbitration include “a summary of the dispute” (article 5 (ii)) and “a preliminary statement of the relief sought by the Claimant” (article 5 (iii)). The Arbitration rules of the German Institution of Arbitration (“the DIS Rules”) provide that arbitration is initiated by filing a statement of claim with the DIS Secretariat and the statement of

¹³ UNCITRAL, Ninth Session, Committee of the Whole II, Summary Records of the Second Meeting, A/CN.9/9/C.2/SR.2 (1976), paras. 35-36.

claim must include, inter alia, the facts and circumstances, which give rise to the claim(s)” (Sec. 6.1). The Rules of Arbitration of the China International Economic and Trade Arbitration Commission (“the CIETAC Rules) provide that the request for arbitration shall include the claim of the claimant (article 10, paragraph 1 (a)).

35. The Working Group might wish to consider whether the notice of arbitration should be separated from the statement of claim.

Content of the notice of arbitration

36. The Working Group might wish to consider whether the content of the notice of arbitration should include all the elements necessary to permit the respondent to take a position on (a) the claimant’s claim, (b) the validity and scope of the arbitration agreement invoked, (c) counterclaims, and (d) the constitution of the tribunal. Such a provision might be added to article 3, paragraph (3).

37. Consistent with the proposal to extend article 1, paragraph (1) to cover disputes that do not arise out of or in relation to a contract, the Working Group might wish to consider whether the notice of arbitration should require an indication of the document(s) or fact(s) out of or in relation to which the dispute arose.

38. As well, for disputes that arise out of a contract, the Working Group might wish to consider whether the notice of arbitration should require that a copy of that contract (rather than merely a reference to it) should be provided.

39. The Working Group might wish to note that, under the LCIA Rules (article 1.1 d)) and the ICC Rules (article 4, paragraph (3) (f)), the claimant is required to make proposals on the place (i.e., the legal seat) and language of the arbitration, if these matters have not already been agreed upon.

Response to the notice of arbitration

40. The Working Group might wish to consider whether the respondent should be given an opportunity to state its position before the constitution of the arbitral tribunal, by responding to the notice of arbitration, and before the submission by the claimant of its statement of claim. This would, in turn, permit the claimant to articulate in its statement of claim both its positive case (on its claim) and its defensive case (on the respondent’s claim). For instance, such opportunity is provided for in the SCC Rules (article 10), the ICC Rules (article 5), and the LCIA Rules (article 3).

41. Allowing the respondent to state its positions in a reply to the notice of arbitration might have the advantage of clarifying at an early stage of the procedure the main issues raised by the dispute. It might be noted however that the UNCITRAL Rules are meant to deal also with ad hoc arbitration cases. Therefore, it might be advisable that revised provisions of the UNCITRAL Rules on the notice of arbitration and its response by the respondent include a level of flexibility on the extent of information to be exchanged between the parties before the constitution of the arbitral tribunal.

Section II. Composition of the arbitral tribunal

Number of Arbitrators — Article 5

“If the parties have not previously agreed on the number of arbitrators (i.e. one or three), and if within fifteen days after the receipt by the respondent of the notice of arbitration the parties have not agreed that there shall be only one arbitrator, three arbitrators shall be appointed.”

42. The *travaux préparatoires* recalled that it was normal practice to have three arbitrators in the arbitration of disputes arising out of international trade transactions. The *travaux préparatoires* also indicate that the question had been examined whether this article should contain a provision stating that, even where the parties fail to reach an agreement on the number of arbitrators, the parties have the right to agree subsequently that there shall be a single arbitrator. It was considered, however, that no express provision to this effect was needed, since the desired result may be obtained by the parties agreeing in writing to modify this article in accordance with article 1.¹⁴

43. The Working Group might wish to note that, according to the LCIA Rules (article 5.4) and AAA Rules (article 5), when the parties have not agreed on the number of arbitrators, preference is given to the appointment of a sole arbitrator, unless the appointing authority determines otherwise in its discretion considering the circumstances of the case. The ICC Rules provide that, where the parties have not agreed upon the number of arbitrators, the court will appoint a sole arbitrator, except “where it appears to the ICC court that the dispute is such as to warrant the appointment of three arbitrators” (article 8, paragraph (2)). The Rules of Arbitration and Conciliation of the International Arbitral Centre of the Austrian Federal Economic Chamber, Vienna (“Vienna Rules”) state no preference but allow discretion on the part of the appointing authority in deciding whether to appoint one or three arbitrators (article 14 (2)).

44. The Working Group might wish to decide whether the default composition for arbitral tribunals of three members should be kept or modified.

Appointment of arbitrators — Articles 6-8

Multiparty arbitration

45. Articles 6 to 8 deal with the appointment of arbitrators, but they do not include provisions dealing with appointment of arbitrators in multi-party cases. When a single arbitration involves more than two parties (multi-party arbitration), proceedings can be more complicated to manage.

46. Rules of various arbitration institutions have been amended so as to accommodate multi-party arbitration (article 10 of the ICC Rules, article 8.1 of the LCIA Rules, rule 9 of the SIAC Rules, article 18 of the WIPO Rules) and deal with that situation in the following manner: where there are multiple parties, whether as claimant or as respondent, and where the dispute is to be referred to three arbitrators, the multiple claimants, jointly, and the multiple respondents, jointly,

¹⁴ Report of the Secretary-General: revised draft set of arbitration rules for optional use in ad hoc arbitration relating to international trade (UNCITRAL Arbitration Rules) (addendum): commentary on the draft UNCITRAL Arbitration Rules (A/CN.9/112/Add.1), Section I, Commentary on article 6, UNCITRAL Yearbook, Volume VII: 1976, Part Two, III, 2.

shall nominate an arbitrator; in the absence of such a joint nomination and where all parties are unable to agree on a method for the constitution of the arbitral tribunal, the appointing authority may appoint each member of the arbitral tribunal and designate one of them to act as chairperson.

47. The Working Group might wish to decide whether a revised version of the UNCITRAL Rules should include provisions on multi-party arbitration.

Challenge of Arbitrators — Articles 9-12

Article 9

“A prospective arbitrator shall disclose to those who approach him in connexion with his possible appointment any circumstances likely to give rise to justifiable doubts as to his impartiality or independence. An arbitrator, once appointed or chosen, shall disclose such circumstances to the parties unless they have already been informed by him of these circumstances.”

Disclosure

48. Article 9 sets forth a two-step disclosure process. The Working Group might wish to consider whether article 9 should make it explicit that the duty of impartiality and independence is a continuing one, as provided for under article 12, paragraph (1), of the Arbitration Model Law and under most of the provisions on disclosure of the rules of arbitration centres (article 7 (3) of the ICC Rules, articles 5.2, 5.3 of the LCIA Rules, article 7 (5) of the Vienna Rules). The Working Group might also wish to consider whether article 9 should contain a clarification that disclosure should be in the form of a written declaration.

Article 12

“1. If the other party does not agree to the challenge and the challenged arbitrator does not withdraw, the decision on the challenge will be made:

“(a) When the initial appointment was made by an appointing authority, by that authority;

“(b) When the initial appointment was not made by an appointing authority, but an appointing authority has been previously designated, by that authority;

“(c) In all other cases, by the appointing authority to be designated in accordance with the procedure for designating an appointing authority as provided for in article 6.

“2. If the appointing authority sustains the challenge, a substitute arbitrator shall be appointed or chosen pursuant to the procedure applicable to the appointment or choice of an arbitrator as provided in articles 6 to 9 except that, when this procedure would call for the designation of an appointing authority, the appointment of the arbitrator shall be made by the appointing authority which decided on the challenge.”

49. Practitioners have noted that this provision, which does not contain time-limits by which the party making the challenge must seek a decision by the appointing authority (and, if necessary, seek the designation of an appointing authority) had on occasion led to delay and uncertainty on the part of the arbitral tribunal on whether the proceedings should be continued.

50. The Working Group might wish to decide whether time limits should be included in any revised version of that provision.

Replacement of an arbitrator — Article 13

“1. In the event of the death or resignation of an arbitrator during the course of the arbitral proceedings, a substitute arbitrator shall be appointed or chosen pursuant to the procedure provided for in articles 6 to 9 that was applicable to the appointment or choice of the arbitrator being replaced.

“2. In the event that an arbitrator fails to act or in the event of the de jure or de facto impossibility of his performing his functions, the procedure in respect of the challenge and replacement of an arbitrator as provided in the preceding articles shall apply.”

Resignation of arbitrators

51. One of the questions raised by article 13 is whether the conditions for resignation of an arbitrator should be defined, in order to dissuade spurious resignations, or at least minimize their impact on the overall process.

52. During the discussions on the preparation of the UNCITRAL Rules, the *travaux préparatoires* show that the Commission heard the views that, although it was recognized that an arbitrator should resign only for exceptional “good reasons”,¹⁵ it was felt that such an obligation could not be effectively enforced.¹⁶

53. The Working Group might wish to consider the following proposals to address that question:

- In multi-member arbitral tribunals, a resignation could be approved by the other arbitrators. This would require an arbitrator to provide reasons for resigning and to submit to the other arbitrators’ scrutiny and judgment, and might be an effective deterrent against ill-considered or plainly tactical resignations. This practice would be consistent with the general rule that the arbitral tribunal is responsible for the conduct of the proceedings.
- A resignation would take effect on a date decided upon by the arbitral tribunal: this rule would permit arbitral tribunals to continue with the proceedings in an orderly way.¹⁷

Nominating process in case of replacement of an arbitrator

54. Concerning the nominating process in case of replacement of an arbitrator, the Working Group might wish to note that rules of several arbitration centres provide for discretion to decide whether or not to follow the original nominating process (for example, article 11.1 of the LCIA Rules). The purpose of that provision is to deprive the party which has appointed an arbitrator whose resignation is not approved of the right to name his or her replacement. Article 13 of the Swiss Rules

¹⁵ UNCITRAL, Ninth Session, Committee of the Whole II, Summary Records of the Fifth Meeting, A/CN.9/9/C.2/SR.5 (1976) 5, para 31.

¹⁶ UNCITRAL, Ninth Session, Committee of the Whole II, Summary Records of the Fifth Meeting, A/CN.9/9/C.2/SR.5 (1976) 5, para 32.

¹⁷ Article 13(5) of the Iran-US CTR Rules (the “Mosk Rule”), which requires an arbitrator who has resigned to “continue to serve ... with respect to all cases in which he had participated in a hearing on the merits”.

provides that the party having nominated the arbitrator concerned shall designate a replacement arbitrator within a prescribed time limit, failing which the Chambers shall appoint a replacement arbitrator. Such mechanism might however not easily fit in the context of ad hoc arbitration.

Truncated tribunals

55. An important question raised by article 13 is whether the language of article 13 (“shall be appointed”, “the procedure in respect of the challenge and replacement (...) shall apply”) precludes the remaining arbitrators from continuing with the proceedings and possibly issuing an award, without a replacement arbitrator being nominated.

56. A revised version of article 13 might include provisions to address the situation where the arbitral tribunal decides to proceed with the arbitration notwithstanding the absence of one of its members, for instance where the arbitral tribunal considers that one of its members is obstructing the progress of the case, including the arbitral tribunal’s deliberations. The Working Group might wish to discuss the potential detrimental consequences of bad-faith withdrawals of arbitrators from arbitral proceedings on the practice of international commercial arbitration and, in that context, consider the extent to which the parties should be able, by agreement, to put beyond doubt the validity of an award issued by a tribunal composed of the remaining arbitrators constituting the majority of the members of the arbitral tribunal (a “truncated” arbitral tribunal).¹⁸ In that respect, the Working Group might bear in mind the provisions of article 32, paragraph (4), which requires that the award state the reason for the absence of one arbitrator’s signature from an award.

57. Article 10 of the AAA Rules provides, inter alia, that the administrator shall determine whether there are sufficient reasons to accept the resignation of an arbitrator. Article 11 then provides that in case “an arbitrator on a three-person tribunal fails to participate in the arbitration for reasons other than those identified in article 10, the two other arbitrators shall have the power in their sole discretion to continue the arbitration and to make any decision, ruling or award, notwithstanding the failure of the third arbitrator to participate”. The ICC Rules provide that the ICC court has discretion, when an arbitrator is replaced, to decide whether or not to follow the original nominating process (article 12, paragraph (4)), and may decide, subsequent to the closing of the proceedings, when it considers appropriate, that the remaining arbitrators shall continue the arbitration (article 12, paragraph (5)).

Repetition of hearings in the event of the replacement of an arbitrator — Article 14

“If under articles 11 to 13 the sole or presiding arbitrator is replaced, any hearings held previously shall be repeated; if any other arbitrator is replaced, such prior hearings may be repeated at the discretion of the arbitral tribunal.”

58. Article 14 defines the procedure for repetition of hearings in the event of replacement of an arbitrator, and specifies that when the sole or presiding arbitrator is replaced, any hearings held previously shall be repeated.

59. The travaux préparatoires indicate that, in recognition of the special role that is played in arbitral proceedings by the sole or presiding arbitrator, this paragraph

¹⁸ A/CN.9/460, paras. 80-91.

provides that when such an arbitrator is replaced, all hearings that were held previously must be repeated.¹⁹

60. It might be noted that article 14 of the Rules of Procedure of the Iran-US Claims Tribunal and article 12, paragraph (4), of the ICC Rules leave this decision entirely to the arbitral tribunal without providing for any compulsory rules. As well, article 14 of the Swiss Rules provides that in case of replacement of an arbitrator, the proceedings shall resume at the stage where the arbitrator who was replaced ceased his or her functions, unless the arbitral tribunal decides otherwise.

61. The Working Group might wish to consider whether the UNCITRAL Rules should be revised so as to leave the decision on whether or not to repeat a hearing when the sole or presiding arbitrator is replaced to the arbitral tribunal.

Section III. Arbitral Proceedings

General Provisions — Article 15

“1. Subject to these Rules, the arbitral tribunal may conduct the arbitration in such manner as it considers appropriate, provided that the parties are treated with equality and that at any stage of the proceedings each party is given a full opportunity of presenting his case.

“2. If either party so requests at any stage of the proceedings, the arbitral tribunal shall hold hearings for the presentation of evidence by witnesses, including expert witnesses, or for oral argument. In the absence of such a request, the arbitral tribunal shall decide whether to hold such hearings or whether the proceedings shall be conducted on the basis of documents and other materials.

“3. All documents or information supplied to the arbitral tribunal by one party shall at the same time be communicated by that party to the other party.”

Paragraph (1)

62. The Working Group might wish to decide whether paragraph (1) should spell out the general principle that arbitral proceedings should be dealt with by the arbitral tribunal without unnecessary delay. Such a rule has been included in arbitration rules of many arbitration institutions. For instance, article 14.1 (ii) of the LCIA Rules imposes the general duty on tribunals at all times “to adopt procedures suitable to the circumstances of the arbitration, avoiding unnecessary delay or expense, so as to provide a fair and efficient means for the final resolution of the parties’ dispute”. Article 15, paragraph (3) of the Swiss Rules provides that “at an early stage of the arbitral proceedings and in consultation with the parties, the arbitral tribunal shall prepare a provisional time-table for the arbitral proceedings, which shall be provided to the parties and, for information to the Chambers”. Article 16, paragraph (2) of the AAA Rules provides that “the tribunal, in exercising its discretion, shall conduct the proceedings with a view to expediting the resolution

¹⁹ Report of the Secretary-General: revised draft set of arbitration rules for optional use in ad hoc arbitration relating to international trade (UNCITRAL Arbitration Rules) (addendum): commentary on the draft UNCITRAL Arbitration Rules (A/CN.9/112/Add.1), Section I, Commentary on article 12, para. 5, UNCITRAL Yearbook, Volume VII: 1976, Part Two, III, 2.

of the dispute”. Article 20, paragraph (3) of the SCC Rules and article 38 (c) of WIPO Rules contain provisions to the same effect.

Preparatory consultations or meetings

63. Preparatory consultations or meetings are increasingly viewed as serving a useful purpose, particularly in more complex international arbitration proceedings. The UNCITRAL Notes on Organizing Arbitral Proceedings provide guidance to both the arbitral tribunal and the parties on matters to be discussed in that context.²⁰

64. Preparatory meetings are expressly provided for under the Iran-US Claims Tribunal Notes to article 15. The Iran-US Claims Tribunal adopted article 15 of the UNCITRAL Rules but provided in Note 4 to the article that “[t]he arbitral tribunal may make an order directing the arbitrating parties to appear for a pre-hearing conference. The pre-hearing conference will normally be held only after the Statement of Defence in the case had been received. The order will state the matters to be considered at the pre-hearing conference”. Article 16, paragraph (2) of the AAA Rules provides that the arbitral tribunal “may conduct a preparatory conference with the parties for the purpose of organizing, scheduling and agreeing to procedures to expedite the subsequent proceedings”. Under article 18 the ICC Rules, the arbitral tribunal must in all cases draw the terms of reference and a timetable for the proceedings.

65. While the general rule contained in current article 15, paragraph (1) does not preclude tribunals from holding preparatory consultations or meetings, the Working Group might wish to consider whether a provision should be included in the UNCITRAL Rules expressly conferring the power on the arbitral tribunal to hold such consultations or meetings “at an appropriate stage of the proceedings”, whether following a request by the parties or at its own initiative.

Consolidation of cases before arbitral tribunals

66. In situations where several distinct disputes arise between the same parties under separate contracts (e.g., related contracts or a chain of contracts) containing separate arbitration clauses, one of the parties might object to all the disputes being resolved in the same proceedings. A party might also initiate a separate arbitration in respect of a distinct claim under the same contract in order to gain a tactical advantage. Consolidation in such situations might provide a more efficient resolution of the disputes between the parties consistently with the general principle

²⁰ These are, in particular, defining the points at issue, the order in which issues are to be decided and defining any relief or remedy sought; possible settlement negotiations and their effect on scheduling proceedings; the language to be used in the proceedings; the place of arbitration and the possibility of meeting outside that place; administrative services that may be needed for the arbitral tribunal to carry out its functions (e.g. hearing arrangements or secretarial assistance); deposits in respect of costs; confidentiality of information relating to the arbitration; arrangements for the exchange of written submissions; other practical details concerning written submissions and evidence (e.g. copies, numbering, references); issues relating to documentary evidence, including time-limits for their submission; disclosure; joint submission of a single set of documentary evidence and the possibility of submitting summaries of voluminous documentary evidence; physical evidence other than documents; issue regarding witnesses (e.g. the manner of taking oral evidence, the order in which the witnesses will be called); experts and expert witnesses; matters relating to the holding of hearings; and possible requirements concerning the filing or delivery of the award.

in article 15, paragraph (1), and also reduce the possibility of inconsistent awards in parallel arbitrations.

67. The Working Group might wish to note that consolidation is permitted under the ICC Rules when all proceedings relate to the same “legal relationship”, on the premise that the parties have consented to consolidate claims by choosing to arbitrate in accordance with the ICC Rules. Article 4, paragraph (6), of the ICC Rules provides: “When a party submits a Request in connection with a legal relationship in respect of which arbitration proceedings between the same parties are already pending under these Rules, the Court may, at the request of a party, decide to include the claims contained in the Request in the pending proceedings provided that the Terms of Reference have not been signed or approved by the Court. Once the Terms of Reference have been signed or approved by the Court, claims may only be included in the pending proceedings subject to the provisions of article 19”.

68. Under the UNCITRAL Rules, consolidation is possible only where the parties specifically so agree.²¹ The Working Group might wish to consider whether, bearing in mind the fact that the UNCITRAL Rules often apply in non-administered cases, additional provisions on that matter should be inserted in a revised version of the UNCITRAL Rules.

Third party intervention in arbitral proceedings

69. Third parties, for example non-governmental organizations, may request for an opportunity to explain their positions, particularly in investment treaty arbitrations. Article 15, paragraph (1), of the UNCITRAL Rules, which provides that “the arbitral tribunal may conduct the arbitration in such manner as it considers appropriate”, could be interpreted as encompassing power of the arbitral tribunal to accept such interventions, for example in the form of *amicus curiae* briefs.

70. The Swiss Rules, for instance, expressly provide, under article 4, paragraph (2), that: “Where a third party requests to participate in arbitral proceedings already pending under these Rules or where a party to arbitral proceedings under these Rules intends to cause a third party to participate in the arbitration, the arbitral tribunal shall decide on such request, after consulting with all parties, taking into account all circumstances it deems relevant and applicable”.

71. The Working Group might wish to consider whether an express provision on third party intervention should be included in any revised version of the UNCITRAL Rules.

Confidentiality of proceedings

72. Articles 25, paragraph (4), and 32, paragraph (5), of the UNCITRAL Rules deal with the confidentiality of hearings and awards respectively, but do not contain rules regarding the confidentiality of the proceedings as such, or of the materials (including pleadings) before the arbitral tribunal.

73. The Working Group might wish to note that following substantial controversy on whether arbitral proceedings should be confidential, the ICC considered including an express provision on confidentiality in its Rules when it most recently revised them in 1998. After extensive consideration, it was decided that a general

²¹ Article 19(3) of the UNCITRAL Rules states that the respondent can bring a counterclaim arising out of the same contract.

confidentiality provision should not be included, and that the matter should be left to be addressed on a case-by-case basis by the arbitrators and the parties (for example, in the Tribunal's Terms of Reference).

74. The Working Group might wish to consider whether an express provision to that effect should be included in a revised version of the UNCITRAL Rules, and, if so, how to define the scope of application of the confidentiality obligation, the persons concerned, and the exceptions to that obligation.

Place of arbitration — Article 16

“1. Unless the parties have agreed upon the place where the arbitration is to be held, such place shall be determined by the arbitral tribunal, having regard to the circumstances of the arbitration.

“2. The arbitral tribunal may determine the locale of the arbitration within the country agreed upon by the parties. It may hear witnesses and hold meetings for consultation among its members at any place it deems appropriate, having regard to the circumstances of the arbitration.

“3. The arbitral tribunal may meet at any place it deems appropriate for the inspection of goods, other property or documents. The parties shall be given sufficient notice to enable them to be present at such inspection.

“4. The award shall be made at the place of arbitration.”

Legal nature of the place of arbitration

75. The Working Group might wish to note that arbitration rules of certain arbitration centres clarify the legal nature of the place of arbitration by referring to it as:

- The seat of the arbitration (article 16, paragraph (1) of the Swiss Rules), as opposed to the places where the arbitral tribunal may meet (article 16, paragraph (3) of the Swiss Rules);
- The seat, defined as the legal place of arbitration (article 16.1 of the LCIA Rules), as opposed to the convenient geographical place for holding hearings, meetings and deliberations (article 16.2 of the LCIA Rules).

76. This terminology clarifies that the choice of the place of arbitration imports the application of the national law governing the arbitral proceedings, including the jurisdiction of the State courts of that place to intervene in the arbitral process (see, for example, article 5 of the Arbitration Model Law). The Working Group might wish to consider whether the UNCITRAL Rules should clarify, by appropriate wording, the legal nature of the place of arbitration.

A/CN.9/WG.II/WP.143/Add.1 [Original: English]

Note by the Secretariat on settlement of commercial disputes: Revision of the UNCITRAL Arbitration Rules, submitted to the Working Group on Arbitration at its forty-fifth session

ADDENDUM

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Introduction

1. At its thirty-ninth session (New York, 19 June-7 July 2006), the Commission agreed that, in respect of future work of the Working Group, priority be given to a revision of the UNCITRAL Arbitration Rules (1976) (“the UNCITRAL Rules”).¹

2. To facilitate discussions of the Working Group on that topic, this note continues from article 17 of the UNCITRAL Rules with an annotated list of possible areas of revision of the UNCITRAL Rules. The list of possible areas of revision in relation to articles 1 to 16 is contained in A/CN.9/WG.II/WP.143.

Notes on a revision of the UNCITRAL Arbitration Rules

Section III. Arbitral Proceedings (*continued*)

Language — Article 17

“1. Subject to an agreement by the parties, the arbitral tribunal shall, promptly after its appointment, determine the language or languages to be used in the proceedings. This determination shall apply to the statement of

¹ *Official Records of the General Assembly, Sixty-first Session, Supplement No. 17 (A/61/17), paras. 182-187.*

claim, the statement of defence, and any further written statements and, if oral hearings take place, to the language or languages to be used in such hearings.

“2. The arbitral tribunal may order that any documents annexed to the statement of claim or statement of defence, and any supplementary documents or exhibits submitted in the course of the proceedings, delivered in their original language, shall be accompanied by a translation into the language or languages agreed upon by the parties or determined by the arbitral tribunal.”

3. The Working Group might wish to decide whether a revised version of article 17, paragraph (1) should expressly require consultation of the arbitrator(s) with the parties to determine the language or languages to be used in the proceedings. Article 14 of the AAA Rules, article 17.3 of the LCIA Rules and article 40 of the WIPO Rules all require the arbitral tribunal to have regard to the parties' view on that question.

Statement of claim — Article 18

“1. Unless the statement of claim was contained in the notice of arbitration, within a period of time to be determined by the arbitral tribunal, the claimant shall communicate his statement of claim in writing to the respondent and to each of the arbitrators. A copy of the contract, and of the arbitration agreement if not contained in the contract, shall be annexed thereto.

“2. The statement of claim shall include the following particulars:

“(a) The names and addresses of the parties;

“(b) A statement of the facts supporting the claim;

“(c) The points at issue;

“(d) The relief or remedy sought.

“The claimant may annex to his statement of claim all documents he deems relevant or may add a reference to the documents or other evidence he will submit.”

4. Article 18 describes the information that must be contained in the statement of claim.

5. The *travaux préparatoires* recall that, although in its statement of claim the claimant is obliged to include “a statement of the facts supporting the claim”, it is not required to annex the documents, which it deems relevant and on which it intends to rely. However, if it wishes to do so, a claimant may still annex the relevant documents. The *travaux préparatoires* indicate that it is believed that, since claimants are generally interested in the resolution of the dispute submitted to arbitration as quickly as possible, they will in a large number of cases annex to their statements of claim the documents or copies of the documents on which they intend to rely. In cases where the claimant does annex a list of such documents or copies of the documents themselves, it is not precluded from submitting additional or substitute documents at a later stage in the arbitral proceedings, in the light of the position taken by the respondent in its statement of defence.²

² Report of the Secretary-General: revised draft set of arbitration rules for optional use in ad hoc arbitration relating to international trade (UNCITRAL Arbitration Rules) (addendum): commentary on the draft UNCITRAL Arbitration Rules (A/CN.9/112/Add.1), Section 1,

6. The Working Group might wish to note that article 41 (c) of the WIPO Rules and article 15.6 of the LCIA Rules require that the statement of claim be accompanied by documentary evidence and all essential documents on which the parties rely.

7. The Working Group might wish to decide whether a revised version of article 18 should be complemented by provisions on documentary evidence to be provided by the claimant with its statement of claim.

Statement of defence — Article 19

“1. Within a period of time to be determined by the arbitral tribunal, the respondent shall communicate his statement of defence in writing to the claimant and to each of the arbitrators.

“2. The statement of defence shall reply to the particulars (b), (c) and (d) of the statement of claim (article 18, para. 2). The respondent may annex to his statement the documents on which he relies for his defence or may add a reference to the documents or other evidence he will submit.

“3. In his statement of defence, or at a later stage in the arbitral proceedings if the arbitral tribunal decides that the delay was justified under the circumstances, the respondent may make a counter claim arising out of the same contract or rely on a claim arising out of the same contract for the purpose of a set-off.

“4. The provisions of article 18, paragraph 2, shall apply to a counter-claim and a claim relied on for the purpose of a set-off.”

Raising claims for the purpose of set-off

8. Article 19, paragraph (3), of the UNCITRAL Rules provides that the respondent may rely on a claim for the purpose of a set-off if the claim arises out of the same contract. Views have been expressed that the arbitral tribunal's competence to consider claims by way of a set-off should, under certain conditions, extend beyond the contract from which the principal claim arises. The reasons cited are procedural efficiency and the desirability of eliminating disputes between the parties.³

9. The Working Group might wish to note that the Swiss Rules provide, under article 21, paragraph (5) that “the arbitral tribunal shall have jurisdiction to hear a set-off defence even when the relationship out of which the defence is said to arise is not within the scope of the arbitration clause or is the object of another arbitration agreement or forum-selection clause”.

10. The Working Group might wish to consider whether a revised version of the UNCITRAL Rules should contain provisions allowing set-off of claims in a wider range of situations.

Commentary on article 17, UNCITRAL Yearbook, Volume VII: 1976, Part Two, III, 2.

³ A/CN.9/460, paras. 72-79.

Pleas as to the jurisdiction of the arbitral tribunal — Article 21

“1. The arbitral tribunal shall have the power to rule on objections that it has no jurisdiction, including any objections with respect to the existence or validity of the arbitration clause or of the separate arbitration agreement.

“2. The arbitral tribunal shall have the power to determine the existence or the validity of the contract of which an arbitration clause forms a part. For the purposes of article 21, an arbitration clause which forms part of a contract and which provides for arbitration under these Rules shall be treated as an agreement independent of the other terms of the contract. A decision by the arbitral tribunal that the contract is null and void shall not entail ipso jure the invalidity of the arbitration clause.

“3. A plea that the arbitral tribunal does not have jurisdiction shall be raised not later than in the statement of defence or, with respect to a counter-claim, in the reply to the counter-claim.

“4. In general, the arbitral tribunal should rule on a plea concerning its jurisdiction as a preliminary question. However, the arbitral tribunal may proceed with the arbitration and rule on such a plea in their final award.”

Paragraph (1)

11. The Working Group might wish to consider whether paragraph (1) should be redrafted along the lines of article 16, paragraph (1), of the Arbitration Model Law, in order to make it clear that the arbitral tribunal has the power on its own motion to raise and decide the existence and scope of its own jurisdiction.

12. Pursuant to article 16, paragraph (2), of the Arbitration Model Law, a party is not precluded from raising a plea that the arbitral tribunal does not have jurisdiction for the reason that it has appointed, or participated in the appointment of, an arbitrator. Article 21 of the UNCITRAL Rules does not contain such a provision.

Paragraph (4)

13. While article 21, paragraph (4) requires that, in general, the arbitral tribunal rule on pleas concerning its jurisdiction as a preliminary question, it permits the arbitral tribunal to rule on such pleas in the final award. This solution is in conformity with the discretion granted to the arbitral tribunal by article 15, paragraph 1, of the UNCITRAL Rules to conduct the arbitral proceedings “in such manner as they consider appropriate” and with paragraph 2 of article 41 of the 1965 Washington Convention on the Settlement of Investment Disputes.⁴

14. The Working Group might wish to consider whether article 21 should make it clear that recourse to domestic courts should only be made after the arbitral tribunal has pronounced itself on its own jurisdiction, and that such recourse should not delay the arbitral proceedings or prevent the arbitral tribunal from making a further award, in accordance with article 16, paragraph (3), of the Arbitration Model Law.

⁴ Report of the Secretary-General: revised draft set of arbitration rules for optional use in ad hoc arbitration relating to international trade (UNCITRAL Arbitration Rules) (addendum): commentary on the draft UNCITRAL Arbitration Rules (A/CN.9/112/Add.1), Section I, Commentary on article 19, UNCITRAL Yearbook, Volume VII: 1976, Part Two, III, 2.

Evidence and hearings — Articles 24 and 25**Article 24**

“1. Each party shall have the burden of proving the facts relied on to support his claim or defence.

“2. The arbitral tribunal may, if it considers it appropriate, require a party to deliver to the tribunal and to the other party, within such a period of time as the arbitral tribunal shall decide, a summary of the documents and other evidence which that party intends to present in support of the facts in issue set out in his statement of claim or statement of defence.

“3. At any time during the arbitral proceedings the arbitral tribunal may require the parties to produce documents, exhibits or other evidence within such a period of time as the tribunal shall determine.”

Paragraph 1

15. The Working Group might wish to consider whether a revised version of article 24 should provide that the power to require a party to produce evidence might be exercised either on the arbitral tribunal's own motion or also on the application of any party. It might be noted that article 22 of the LCIA Rules (article 22), rule 25 of the SIAC Rules, and article 48 (b) of the WIPO Rules contain such a provision.

Interim measures of protection — Article 26

“1. At the request of either party, the arbitral tribunal may take any interim measures it deems necessary in respect of the subject matter of the dispute, including measures for the conservation of the goods forming the subject matter in dispute, such as ordering their deposit with a third person or the sale of perishable goods.

“2. Such interim measures may be established in the form of an interim award. The arbitral tribunal shall be entitled to require security for the costs of such measures.

“3. A request for interim measures addressed by any party to a judicial authority shall not be deemed incompatible with the agreement to arbitrate, or as a waiver of that agreement.”

16. Article 26 of the UNCITRAL Rules deals with interim measures in lesser detail than the new provisions dealing with interim measures set out in a new Chapter IV A of the Arbitration Model Law, adopted by the Commission at its thirty-ninth session.⁵ The Working Group might wish to consider whether, and if so, to what extent, article 26 of the UNCITRAL Rules should be revised in light of the new Chapter IV A.

Experts — Article 27

“1. The arbitral tribunal may appoint one or more experts to report to it, in writing, on specific issues to be determined by the tribunal. A copy of the

⁵ A/CN.9/592, annex I.

expert's terms of reference, established by the arbitral tribunal, shall be communicated to the parties.

"2. The parties shall give the expert any relevant information or produce for his inspection any relevant documents or goods that he may require of them. Any dispute between a party and such expert as to the relevance of the required information or production shall be referred to the arbitral tribunal for decision.

"3. Upon receipt of the experts report, the arbitral tribunal shall communicate a copy of the report to the parties who shall be given the opportunity to express, in writing, their opinion on the report. A party shall be entitled to examine any document on which the expert has relied in his report.

"4. At the request of either party the expert, after delivery of the report, may be heard at a hearing where the parties shall have the opportunity to be present and to interrogate the expert. At this hearing either party may present expert witnesses in order to testify on the points at issue. The provisions of article 25 shall be applicable to such proceedings."

17. The article emphasizes the role of a tribunal-appointed expert and only expressly deals with expert witnesses presented by parties after the report of the tribunal-appointed expert has been delivered.

18. The Working Group might wish to note that article 20, paragraph (4), of the ICC Rules, article 55 (a) of the WIPO Rules and article 27, paragraph (1), of the Swiss Rules provide that the arbitral tribunal may appoint experts "after having consulted the parties".

19. The Working Group might wish to consider whether a revised version of the UNCITRAL Rules should provide that an arbitral tribunal should consult the parties before appointing any expert to report to it.

20. As well, the Working Group might wish to consider whether article 27 should provide that an arbitral tribunal be given the power to direct any experts presented by the parties to meet with the tribunal-appointed expert in order to attempt to reach an agreement on contentious issues or, at least, to narrow them down.

Section IV. The award

Decisions — Article 31

"1. When there are three arbitrators, any award or other decision of the arbitral tribunal shall be made by a majority of the arbitrators.

"2. In the case of questions of procedure, when there is no majority or when the arbitral tribunal so authorizes, the presiding arbitrator may decide on his own, subject to revision, if any, by the arbitral tribunal."

Paragraph (1)

21. Paragraph (1) requires that an award be made by a majority of the arbitrators in cases where there is a three-member arbitral tribunal.

22. The *travaux préparatoires* emphasize that, at least two of the three arbitrators must concur in the award; however, it is not required that the presiding arbitrator be

one of the two arbitrators who agree on the award. Moreover, the *travaux préparatoires* indicate that if a majority of arbitrators fail to agree on an award, the arbitral tribunal must resolve the deadlock in accordance with the relevant law and practice at the place of the arbitration, which is the place where (according to article 16, paragraph 4 of these Rules) the award must be made. The law and practice in many jurisdictions require arbitrators to continue their deliberations until they arrive at a majority decision.⁶

23. The Working Group might wish to note that article 25, paragraph (1) of the ICC Rules addresses the case where no majority exists and provides that: “When the Arbitral Tribunal is composed of more than one arbitrator, an award is given by a majority decision. If there be no majority, the award shall be made by the chairman of the Arbitral Tribunal alone”. Similar provisions are included in article 26.3 of the LCIA Rules, article 61 of the WIPO Rules, article 26, paragraph (2) of the Vienna Rules and article 31 of the Swiss Rules.

24. The Working Group might wish to consider whether article 31, paragraph (1) should include a rule to address the case where no majority exists, as provided in many arbitration rules.

Form and effect of the award — Article 32

“1. In addition to making a final award, the arbitral tribunal shall be entitled to make interim, interlocutory, or partial awards.

“2. The award shall be made in writing and shall be final and binding on the parties. The parties undertake to carry out the award without delay.

“3. The arbitral tribunal shall state the reasons upon which the award is based, unless the parties have agreed that no reasons are to be given.

“4. An award shall be signed by the arbitrators and it shall contain the date on which and the place where the award was made. Where there are three arbitrators and one of them fails to sign, the award shall state the reason for the absence of the signature.

“5. The award may be made public only with the consent of both parties.

“6. Copies of the award signed by the arbitrators shall be communicated to the parties by the arbitral tribunal.

“7. If the arbitration law of the country where the award is made requires that the award be filed or registered by the arbitral tribunal, the tribunal shall comply with this requirement within the period of time required by law.”

Paragraph (2)

25. The Working Group might wish to consider including a new provision modelled on article 28, paragraph (6), of the ICC Rules, and article 26.9 of the LCIA Rules, according to which the award shall be subject to no appeal or other recourse before any court or other authority so as to exclude, for example, an appeal on a point of law, but not to exclude challenges to the award (for example, on

⁶ Report of the Secretary-General: revised draft set of arbitration rules for optional use in ad hoc arbitration relating to international trade (UNCITRAL Arbitration Rules) (addendum): commentary on the draft UNCITRAL Arbitration Rules A/CN.9/112/Add.1, Section 1, Commentary on article 27, UNCITRAL Yearbook, Volume VII: 1976, Part Two, III, 2.

matters such as lack of jurisdiction or violation of due process). Article 28, paragraph (6) of the ICC Rules provides that: “(...) the parties undertake to carry out any Award without delay and shall be deemed to have waived their right to any form of recourse insofar as such waiver can validly be made”. Article 26.9 of the LCIA Rules provides that: “(...) the parties also waive irrevocably their right to any form of appeal, review or recourse to any State court or other judicial authority, insofar as such waiver may be validly made”.

Paragraph (5)

26. Paragraph 5 requires the consent of the parties for the award to be made public. The Working Group might wish to consider whether the UNCITRAL Rules should address the situation where a party is under a legal duty to disclose an award or its tenor.

Paragraph (7)

27. The Working Group might wish to consider an amendment to paragraph (7) so as to avoid an onerous burden being placed on the arbitral tribunal in countries where registration requirements are ambiguous. For this purpose, the compliance of the tribunal with the said requirements could be made subject to the timely request of any party.

Time-limit for rendering the award

28. The Working Group might wish to consider whether a time-limit should be provided for the rendering of the award. An example of such time-limit is contained in article 24, paragraph (1) of the ICC Rules, which provides that an award should be rendered within six months, starting from the date of the last signature by the arbitral tribunal or the parties of the terms of reference. Similarly, article 42, paragraph (1) of the CIETAC Rules provides that the award shall be rendered within six months from the date on which the arbitral tribunal is formed. If such a rule is to be provided in the UNCITRAL Rules, a method of extending such time-limit may be useful.

Possible new paragraph (8)

29. The Working Group might wish to consider whether a principle for interpreting the UNCITRAL Rules, in addition to the general principle contained in article 15, should be added. To that end, the Working Group might wish to consider including a new rule providing that it is the essential duty of arbitrators and parties to act in the spirit of the UNCITRAL Rules, even in circumstances where no specific provision covers the situation in question. The Working Group might wish to consider whether it would be appropriate to link this general duty to the enforceability of the award, providing that the arbitral tribunal and the parties shall make every effort to ensure that the award would be legally enforceable.

Applicable law — Amiable compositeur — Article 33

“1. The arbitral tribunal shall apply the law designated by the parties as applicable to the substance of the dispute. Failing such designation by the parties, the arbitral tribunal shall apply the law determined by the conflict of laws rules which it considers applicable.

“2. The arbitral tribunal shall decide as *amiable compositeur* or *ex aequo et bono* only if the parties have expressly authorized the arbitral tribunal to do so and if the law applicable to the arbitral procedure permits such arbitration.

“3. In all cases, the arbitral tribunal shall decide in accordance with the terms of the contract and shall take into account the usages of the trade applicable to the transaction.”

Paragraph (1)

Law applicable to the substance of the dispute

30. The Working Group might wish to note that article 28 of the Arbitration Model Law provides that the parties might designate the “rules of law” applicable to the substance of the dispute, whereas paragraph (1) refers to the “applicable law”. The term “rules of law”, until its inclusion in the Arbitration Model Law, had only been used in the 1965 Washington Convention on the Settlement of Investment Disputes (article 42), and the arbitration laws of France and Djibouti.⁷ The term “rules of law” is understood to be wider than the term “law”, allowing the parties “to designate as applicable to their case rules of more than one legal system, including rules of law which have been elaborated on the international level”.⁸ The Working Group might wish to consider adopting that term in a revised version of article 33 of the UNCITRAL Rules.

Paragraph (2)

Ex aequo et bono — Amiable compositeur

31. The Working Group might wish to note that rules of certain arbitration centres (article 17.3 of the ICC Rules, article 22.4 of the LCIA Rules and article 28.3 of the AAA Rules) require authorization by the parties for the arbitral tribunal to decide as *amiable compositeur* or *ex aequo et bono* and do not include a requirement that the law applicable to the arbitral procedure permit an arbitration to be decided *ex aequo et bono*. The Working Group might wish to consider whether such an amendment would be appropriate in the context of the UNCITRAL Rules.

Interpretation of the award — Article 35

“1. Within 30 days after the receipt of the award, either party, with notice to the other party, may request that the arbitral tribunal give an interpretation of the award.

“2. The interpretation shall be given in writing within 45 days after the receipt of the request. The interpretation shall form part of the award and the provisions of article 32, paragraphs 2 to 7, shall apply.”

32. The Working Group might wish to consider whether this article should only apply where there is a need to interpret what the award orders the parties to do.

Correction of the award — Article 36

“1. Within 30 days after the receipt of the award, either party, with notice to the other party, may request the arbitral tribunal to correct in the award any errors in

⁷ A/CN.9/264, para. 4.

⁸ Ibid.

computation, any clerical or typographical errors, or any errors of similar nature. The arbitral tribunal may within 30 days after the communication of the award make such corrections on its own initiative.

“2. Such corrections shall be in writing, and the provisions of article 32, paragraphs 2 to 7, shall apply.”

33. The Working Group might wish to consider whether the scope of article 36 should be broadened to allow correction of the award if an arbitrator omits to sign the award or omits to state the date or place of the award.

Additional award — Article 37

“1. Within thirty days after the receipt of the award, either party, with notice to the other party, may request the arbitral tribunal to make an additional award as to claims presented in the arbitral proceedings but omitted from the award.

“2. If the arbitral tribunal considers the request for an additional award to be justified and considers that the omission can be rectified without any further hearings or evidence, it shall complete its award within sixty days after the receipt of the request.

“3. When an additional award is made, the provisions of article 32, paragraphs 2 to 7, shall apply.”

34. The Working Group might wish to consider whether the requirement that “the omission can be rectified without any further hearings or evidence” should be retained on the basis that arbitrators should be free to convene hearings or request further evidence or pleadings.

Costs — Articles 38-40

Article 38

“The arbitral tribunal shall fix the costs of arbitration in its award. The term “costs” includes only:

“(a) The fees of the arbitral tribunal to be stated separately as to each arbitrator and to be fixed by the tribunal itself in accordance with article 39;

“(b) The travel and other expenses incurred by the arbitrators;

“(c) The costs of expert advice and of other assistance required by the arbitral tribunal;

“(d) The travel and other expenses of witnesses to the extent such expenses are approved by the arbitral tribunal;

“(e) The costs for legal representation and assistance of the successful party if such costs were claimed during the arbitral proceedings, and only to the extent that the arbitral tribunal determines that the amount of such costs is reasonable;

“(f) Any fees and expenses of the appointing authority as well as the expenses of the Secretary General of the Permanent Court of Arbitration at The Hague.”

35. The Working Group might wish to consider whether the list of elements included in article 38 is exhaustive.
36. As well, the following questions might be raised in relation to that article:
- Whether subparagraphs (b)-(d) should be qualified by the word “reasonable” as is the case with paragraph (e) (which refers to legal costs). This word might be considered as constituting a useful reminder to arbitrators that they must act efficiently in all respects in the conduct of the arbitration (as provided in article 15, paragraph (1) of the UNCITRAL Rules);
 - Whether fees and expenses of a secretary appointed by the arbitral tribunal should be expressly included in element (c).

Article 39

“1. The fees of the arbitral tribunal shall be reasonable in amount, taking into account the amount in dispute, the complexity of the subject matter, the time spent by the arbitrators and any other relevant circumstances of the case.

“2. If an appointing authority has been agreed upon by the parties or designated by the Secretary General of the Permanent Court of Arbitration at The Hague, and if that authority has issued a schedule of fees for arbitrators in international cases which it administers, the arbitral tribunal in fixing its fees shall take that schedule of fees into account to the extent that it considers appropriate in the circumstances of the case.

“3. If such appointing authority has not issued a schedule of fees for arbitrators in international cases, any party may at any time request the appointing authority to furnish a statement setting forth the basis for establishing fees which is customarily followed in international cases in which the authority appoints arbitrators. If the appointing authority consents to provide such a statement, the arbitral tribunal in fixing its fees shall take such information into account to the extent that it considers appropriate in the circumstances of the case.

“4. In cases referred to in paragraphs 2 and 3, when a party so requests and the appointing authority consents to perform the function, the arbitral tribunal shall fix its fees only after consultation with the appointing authority which may make any comment it deems appropriate to the arbitral tribunal concerning the fees.”

37. The Working Group might wish to consider whether it is necessary to provide more guidance on the question of the fees of the arbitrators in any revision of the UNCITRAL Rules. Various solutions might be envisaged to address that matter:
- The arbitral tribunal and the parties would be explicitly encouraged to agree on the method of calculating the arbitral tribunal’s fees from the outset, at a consultation or preparatory meeting. Such a provision might be included in a revised version of article 15;
 - The appointing authority, or if none has been agreed upon or designated, the authority appointed or designated by the Secretary-General of the Permanent Court of Arbitration, would have the power to resolve any objection by a party to an arbitral tribunal’s decision on its fees pursuant to articles 38 and 39, paragraph (1).

Article 40

“1. Except as provided in paragraph 2, the costs of arbitration shall in principle be borne by the unsuccessful party. However, the arbitral tribunal may apportion each of such costs between the parties if it determines that apportionment is reasonable, taking into account the circumstances of the case.

“2. With respect to the costs of legal representation and assistance referred to in article 38, paragraph (e), the arbitral tribunal, taking into account the circumstances of the case, shall be free to determine which party shall bear such costs or may apportion such costs between the parties if it determines that apportionment is reasonable.

“3. When the arbitral tribunal issues an order for the termination of the arbitral proceedings or makes an award on agreed terms, it shall fix the costs of arbitration referred to in article 38 and article 39, paragraph 1, in the text of that order or award.

“4. No additional fees may be charged by an arbitral tribunal for interpretation or correction or completion of its award under articles 35 to 37.”

38. The Working Group might wish to decide whether to retain article 40, paragraph (4), as this provision is not found in revised versions of arbitration rules of most arbitration institutions.

Miscellaneous provision**Liability of arbitrators**

39. The Working Group might wish to consider whether the question of liability of arbitrators needs to be further examined in the context of the UNCITRAL Rules. At present, neither the UNCITRAL Rules nor the Arbitration Model Law address that question. Consideration may also be given to extending the scope of any provision on liability to persons or institutions performing the function of an appointing authority under the UNCITRAL Rules.

40. Existing arbitration rules offer two possible approaches. The first, adopted in the ICC Rules (article 34), is an unqualified exclusion of liability: neither the arbitrators, nor the Court and its members, nor the ICC and its employees, nor the ICC National Committees shall be liable to any person for any act of omission in connection with the arbitration. A similar approach has been adopted in the Vienna Rules. The second, and more common approach is reflected in the Introductory Note of the IBA Rules of Ethics for International Arbitrators (1987), which provides that “international arbitrators should in principle be granted immunity from suit under national laws, except in extreme case of wilful or reckless disregard of their legal obligations”. The LCIA Rules (article 31.1) and the AAA Rules (article 35) similarly refer to “conscious and deliberate wrongdoing”.

**C. Report of the Working Group on Arbitration on the work of its
forty-sixth session (New York, 5-9 February 2007)**

(A/CN.9/619) [Original: English]

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I. Introduction

1. At its thirty-first session (New York, 1-12 June 1998), the Commission, with reference to discussions at the special commemorative New York Convention Day held in June 1998 to celebrate the fortieth anniversary of the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York, 1958) (“the New York Convention”), considered that it would be useful to engage in a discussion of possible future work in the area of arbitration. It requested the Secretariat to prepare a note that would serve as a basis for the consideration of the Commission at its next session.¹

2. At its thirty-second session (Vienna, 17 May-4 June 1999), the Commission had before it a note entitled “Possible future work in the area of international commercial arbitration” (A/CN.9/460). Welcoming the opportunity to discuss the desirability and feasibility of further development of the law of international commercial arbitration, the Commission generally considered that the time had come to assess the extensive and favourable experience with national enactments of the UNCITRAL Model Law on International Commercial Arbitration (1985) (“the UNCITRAL Arbitration Model Law”), as well as the use of the UNCITRAL Arbitration Rules (“the UNCITRAL Arbitration Rules” or “the Rules”) and the UNCITRAL Conciliation Rules, and to evaluate, in the universal forum of the

¹ *Official Records of the General Assembly, Fifty-third Session, Supplement No. 17 (A/53/17)*, para. 235.

Commission, the acceptability of ideas and proposals for improvement of arbitration laws, rules and practices.² When the Commission discussed that topic, it left open the question of what form its future work might take. It was agreed that decisions on the matter should be taken later as the substance of proposed solutions became clearer. Uniform provisions might, for example, take the form of a legislative text (such as model legislative provisions or a treaty) or a non-legislative text (such as a model contractual rule or a practice guide).³

3. At its thirty-ninth session (New York, 19 June-7 July 2006), the Commission agreed that the topic of revising the UNCITRAL Arbitration Rules should be given priority. The Commission noted that, as one of the early instruments elaborated by UNCITRAL in the field of arbitration, the UNCITRAL Arbitration Rules were recognized as a very successful text, adopted by many arbitration centres and used in many different instances, such as, for example, in investor-State disputes. In recognition of the success and status of the UNCITRAL Arbitration Rules, the Commission was generally of the view that any revision of the UNCITRAL Arbitration Rules should not alter the structure of the text, its spirit, its drafting style, and should respect the flexibility of the text rather than make it more complex. It was suggested that the Working Group should undertake to carefully define the list of topics which might need to be addressed in a revised version of the UNCITRAL Arbitration Rules.⁴

4. The topic of arbitrability was said to be an important question, which should also be given priority. It was said that it would be for the Working Group to define whether arbitrable matters could be defined in a generic manner, possibly with an illustrative list of such matters, or whether the legislative provision to be prepared in respect of arbitrability should identify the topics that were not arbitrable. It was suggested that studying the question of arbitrability in the context of immovable property, unfair competition and insolvency could provide useful guidance for States. It was cautioned however that the topic of arbitrability was a matter raising questions of public policy, which was notoriously difficult to define in a uniform manner, and that providing a pre-defined list of arbitrable matters could unnecessarily restrict a State's ability to meet certain public policy concerns that were likely to evolve over time.⁵

5. Other topics mentioned for possible inclusion in the future work of the Working Group included issues raised by online dispute resolution. It was suggested that the UNCITRAL Arbitration Rules, when read in conjunction with other instruments, such as the UNCITRAL Model Law on Electronic Commerce and the United Nations Convention on the Use of Electronic Communications in International Contracts, already accommodated a number of issues arising in the online context. Another topic was the issue of arbitration in the field of insolvency. Yet another suggestion was made to address the impact of anti-suit injunctions on international arbitration. A further suggestion was made to consider clarifying the notions used in article I, paragraph (1), of the New York Convention of "arbitral awards made in the territory of a State other than the State where the recognition and enforcement of such awards are sought" or "arbitral awards not considered as domestic awards in the State where their recognition and enforcement are sought",

² Ibid., *Fifty-fourth Session, Supplement No. 17 (A/54/17)*, para. 337.

³ Ibid., para. 338.

⁴ Ibid., *Sixty-first Session, Supplement No. 17 (A/61/17)*, para. 184.

⁵ Ibid., para. 185.

which were said to have raised uncertainty in some State courts. The Commission also heard with interest a statement made on behalf of the International Cotton Advisory Committee suggesting that work could be undertaken by the Commission to promote contract discipline, effectiveness of arbitration agreements and enforcement of awards in that industry.⁶

6. After discussion, the Commission was generally of the view that several matters could be dealt with by the Working Group in parallel. The Commission agreed that the Working Group should resume its work on the question of a revision of the UNCITRAL Arbitration Rules. It was also agreed that the issue of arbitrability was a topic which the Working Group should also consider. As to the issue of online dispute resolution, it was agreed that the Working Group should place the topic on its agenda but, at least in an initial phase, deal with the implications of electronic communications in the context of the revision of the UNCITRAL Arbitration Rules.⁷

II. Organization of the session

7. The Working Group, which was composed of all States members of the Commission, held its forty-sixth session in New York, from 5 to 9 February 2007. The session was attended by the following States members of the Working Group: Argentina, Australia, Austria, Belarus, Benin, Cameroon, Canada, Chile, China, Colombia, Croatia, Czech Republic, Fiji, France, Germany, Guatemala, India, Iran (Islamic Republic of), Italy, Japan, Kenya, Madagascar, Mexico, Nigeria, Poland, Republic of Korea, Russian Federation, Rwanda, Singapore, South Africa, Spain, Sweden, Switzerland, Thailand, Turkey, United Kingdom of Great Britain and Northern Ireland, United States of America and Venezuela (Bolivarian Republic of).

8. The session was attended by observers from the following States: Albania, Bahrain, Bulgaria, Cuba, Egypt, El Salvador, Finland, Greece, Haiti, Honduras, Ireland, Jamaica, Kuwait, Liberia, Malaysia, Mauritius, Nepal, Netherlands, Romania and Trinidad and Tobago.

9. The session was also attended by observers from the following international intergovernmental organizations invited by the Commission: Asian African Legal Consultative Organization, European Community and Permanent Court of Arbitration.

10. The session was also attended by observers from the following international non-governmental organizations invited by the Commission: American Arbitration Association (AAA), American Bar Association (ABA), Arab Union for International Arbitration (AUIA), Asia Pacific Regional Arbitration Group (APRAG), Association of the Bar of the City of New York (ABCNY), Cairo Regional Centre for International Commercial Arbitration (CRCICA), Center for International Environmental Law (CIEL), Chartered Institute of Arbitrators, Forum for International Commercial Arbitration (FICA), International Arbitration Institute (IAI), International Chamber of Commerce (ICC), International Cotton Advisory Committee (ICAC), International Institute for Sustainable Development (IISD), Kuala Lumpur Regional Centre for Arbitration (KLRCA), the London Court of International Arbitration (LCIA), Milan Club of Arbitrators, Moot Alumni

⁶ Ibid., para. 186.

⁷ Ibid., para. 187.

Association, NAFTA Article 2022 Advisory Committee, School of International Arbitration of the Queen Mary University of London, Swiss Arbitration Association (ASA), the European Law Students' Association and *Union Internationale des Avocats* (UIA).

11. The Working Group elected the following officers:

Chairman: Mr. Michael Schneider (Switzerland);

Rapporteur: Mr. Andrés Jana (Chile).

12. The Working Group had before it the following documents: (a) provisional agenda (A/CN.9/WG.II/WP.144); (b) a note by the Secretariat on a revision of the UNCITRAL Arbitration Rules pursuant to the deliberations of the Working Group at its forty-fifth session (A/CN.9/WG.II/WP.145 and A/CN.9/WG.II/WP.145/Add.1).

13. The Working Group adopted the following agenda:

1. Opening of the session.
2. Election of officers.
3. Adoption of the agenda.
4. Revision of the UNCITRAL Arbitration Rules and organization of future work.
5. Other business.
6. Adoption of the report.

III. Deliberations and decisions

14. The Working Group resumed its work on agenda item 4 on the basis of the notes prepared by the Secretariat (A/CN.9/WG.II/WP.145 and A/CN.9/WG.II/WP.145/Add.1). The deliberations and conclusions of the Working Group with respect to this item are reflected in chapter IV. The Secretariat was requested to prepare a draft of revised UNCITRAL Arbitration Rules, based on the deliberations and conclusions of the Working Group.

IV. Revision of the UNCITRAL Arbitration Rules

15. The Working Group recalled the mandate given by the Commission at its thirty-ninth session (New York, 19 June-7 July 2006) and set out above (see above paragraph 3). The Working Group recalled as well its decision that harmonizing the provisions of the UNCITRAL Arbitration Rules with the corresponding provisions of the UNCITRAL Arbitration Model Law should not be automatic but rather considered only where appropriate (A/CN.9/614, para. 21).

16. The Working Group agreed to resume discussions on the revision of the Rules on the basis of documents A/CN.9/WG.II/WP.145 and A/CN.9/WG.II/WP.145/Add.1 and the proposed revisions contained therein.

General remarks on the reference to “parties” in the Rules

17. The Working Group agreed on the principle to replace words such as “both parties”, “either party”, “one of the parties” with the more generic formulation of “parties” in the text of the Rules, where appropriate, so as to encompass multi-party arbitration.

Section I. Introductory rules**Scope of application****Article 1***Title*

18. The Working Group considered whether the title of article 1 should read “Applicability” instead of “Scope of application”, given that article 1 contained provisions on the principles of application of the UNCITRAL Arbitration Rules and was not limited to matters relating to the scope of application. After discussion, it was agreed to retain the existing title without change, following the generally agreed principle that the Working Group should avoid making unnecessary changes to the Rules.

*Paragraph (1)**“parties to a contract”*

19. The Working Group proceeded to consider two options in respect of the question whether paragraph (1) should contain a reference to the “parties”. It was noted that option 1 most closely corresponded to the existing version of the Rules, by including a reference to “parties”, whereas option 2 implemented a suggestion made in the Working Group at its forty-fifth session to delete any reference to “parties” in the opening words of paragraph (1) (A/CN.9/614, para. 34).

20. Some support was also expressed for option 2 for the reason that it provided flexibility and that it would more appropriately cover arbitrations involving situations such as disputes in the context of bilateral investment treaties, where the parties to an investment arbitration treaty containing an arbitration clause differed from the parties to the arbitration. However, preference was expressed for option 1 as it had the advantage of clarifying that disputes of a non-contractual nature would also be covered by the Rules (see below, paragraphs 21-24).

“disputes in relation to that contract”

21. The Working Group considered whether the words “in relation to that contract”, contained in paragraph (1) should be omitted so as not to suggest any limitation with respect to the types of disputes that parties could submit to arbitration. The Working Group agreed that paragraph (1) should be widened to avoid ambiguity on the scope of application of the Rules and ensure that it not be limited to disputes of a contractual nature only. The Working Group agreed that the words “to a contract” and “in relation to that contract” should be deleted.

“in respect of a defined legal relationship, whether contractual or not,”

22. The Working Group considered whether the words “in respect of a defined legal relationship, whether contractual or not,” should be added to paragraph (1). It was suggested that these words should not be added as they might unnecessarily limit the scope of the Rules and could raise difficult interpretative questions. It was also said that the reference to a “defined legal relationship” might not easily be accommodated in certain legal systems.

23. In response, it was said that the words “in respect of a defined legal relationship, whether contractual or not” were well recognized given that they were derived from the New York Convention, and were also included in article 7, paragraph (1) of the UNCITRAL Arbitration Model Law. In favour of their retention, it was said that these words put beyond doubt that a broad range of disputes, whether or not arising out of a contract, could be submitted to arbitration under the Rules and that their deletion could give rise to ambiguity. It was also suggested that these words would have educational impact on the future developments in the field of international arbitration.

24. Subject to possible review at a future session, the Working Group expressed strong support for the retention of option 1, with the addition of the words “in respect of a defined legal relationship, whether contractual or not”.

The writing requirement for the agreement to arbitrate under the Rules and for modification of the Rules

25. The Working Group considered whether to retain the requirements in paragraph (1) that both the agreement of the parties to refer disputes to arbitration under the UNCITRAL Arbitration Rules, and any modification thereto, should be in writing.

26. It was recalled that the purpose of the requirement that the arbitration agreement be in writing was to set out the scope of application of the UNCITRAL Arbitration Rules and, unlike the function of the form requirement under the UNCITRAL Arbitration Model Law, was separate from the question of the validity of the arbitration agreement (which was governed by the applicable law) or from the question of enforcement under the New York Convention.

27. It was recalled that the *travaux préparatoires* of the UNCITRAL Arbitration Rules indicated that the purpose of the requirement that an arbitration agreement be in writing was to avoid uncertainty as to whether the UNCITRAL Arbitration Rules had been made applicable.⁸ Diverging views were expressed on whether the increased use of the Rules had reduced the risk of such uncertainty.

28. In support of deleting the writing requirement, it was said that the form of arbitration agreement was a matter that should be left to the applicable law. It was said that the UNCITRAL Arbitration Rules should, in the interests of harmonization of international arbitration, take a consistent approach with the work of the Working Group in respect of the UNCITRAL Arbitration Model Law, which had reflected a broad and liberal understanding of the form requirement. It was suggested that

⁸ Report of the Secretary-General: revised draft set of arbitration rules for optional use in ad hoc arbitration relating to international trade (UNCITRAL Arbitration Rules) (addendum): commentary on the draft UNCITRAL Arbitration Rules (A/CN.9/112/Add.1), Section I, Commentary on article 1, UNCITRAL Yearbook, Volume VII: 1976, Part Two, III, 2.

retention of the writing requirement in the Rules could create difficulties in those States that had deleted any such requirement in their legislation. It was said that, if such a requirement were to be maintained, it should be defined and that including such a definition would go beyond the usual scope of arbitration rules. Also, it was said that article 19, paragraph (1), of the UNCITRAL Arbitration Model Law, which provided that “Subject to the provisions of this Law, the parties are free to agree on the procedure to be followed by the arbitral tribunal in conducting the proceedings”, did not require any written agreement of the parties on the proceedings, and therefore, as a matter of consistency, the Rules should not go beyond the requirements of the UNCITRAL Arbitration Model Law.

29. It was also noted that issues such as whether the writing requirement had been met and how it could be met had given rise to a substantial amount of litigation. As well, it was pointed out that there was uncertainty as to whether the writing requirement applied to the agreement to arbitrate or to the parties’ agreement on the application of the UNCITRAL Arbitration Rules, and that, for that reason, that requirement should be removed.

30. In support of preserving a reference to the writing requirement, it was said that there was no uniform approach to that question, some jurisdictions having omitted that requirement while others maintained it. In addition, it was noted that the writing requirement could have two functions. First, to remind the parties that, depending on the applicable law, the agreement to arbitrate might only be valid if made in writing and second, from the point of view of convenience, to provide a basis upon which an appointing authority could appoint arbitrators. It was stated that a requirement that the parties define their arbitration agreement in writing would promote good practices and would provide an opportunity for parties to clarify which version of the Rules would apply.

31. Subject to possible review at a future session, the Working Group expressed strong support for deletion of the writing requirement from article 1.

Applicable version of the UNCITRAL Arbitration Rules

32. It was noted that article 1 dealt with the scope of application of the UNCITRAL Arbitration Rules, without determining which version of the Rules would apply in case of revision. The Working Group considered variants 1, 2 and 3 as proposed in document A/CN.9/WG.II/WP.145.

33. Variant 1, which corresponded to the current wording of the UNCITRAL Arbitration Rules and did not include any indication as to the applicable version of the Rules in case of revision, did not receive support.

34. Support was expressed for variant 2, which provided that the applicable version of the Rules be the one “as in effect on the date of commencement of the arbitration, subject to such modification as the parties may agree”. It was noted that that variant corresponded with the approach taken by a number of arbitration institutions when revising their rules.

35. Variant 3 received considerable support as providing a precise and simple rule, which put the parties on notice that, if they did not express their agreement to apply the Rules as in effect on the date of their agreement, then the Rules as in effect on the date of the commencement of the arbitration should be presumed to apply. In that respect, it was observed that variant 3 more comprehensively set out the options

of parties to apply either the most recent version of the Rules to their dispute or the Rules in existence at the time the arbitration agreement was made.

36. However concern was expressed that variant 3 could lead to a situation where a default rule would apply retroactively to agreements made before the adoption of the revised Rules without sufficient regard for the principle of party autonomy. To avoid that situation, a proposal was made to reverse the presumption under variant 3 along the following lines: “Unless the parties have agreed to apply the Rules in effect on the date of commencement of the arbitration, the parties shall be deemed to have submitted to the Rules as in effect on the date of their agreement”. Another proposal was made that: “Unless the parties have otherwise agreed, the parties shall be deemed to have submitted to the Rules in effect at the date of the arbitration agreement”. Yet another proposal was made to retain variant 3 with a clarification that the revised Rules did not apply to agreements concluded before the revision of the Rules was adopted.

37. Some support was expressed for those proposals. However, it was recalled that the proposals might run contrary to the expectation that the most recent version of the Rules would apply, as illustrated by the practice of some arbitral institutions suggesting that parties often preferred using the updated rules. The view was expressed that the preference for the most recent rules could also result from a parallel to be drawn between a revision of the rules and the adoption of new legislation on matters of procedure. In response, it was stated that the difference in nature between model contractual rules and a piece of legislation made it unadvisable to pursue such comparison. It was widely felt that, in case of disagreement or doubt regarding the chosen version of the Rules, it would be for the arbitral tribunal to interpret the will of the parties. In the view of some delegations, the provision on the applicable version of the Rules should apply only to future changes to the Rules.

38. After discussion, preference was expressed for variant 3. The Working Group agreed to revisit the question of the applicable version of the Rules once it had completed its review of the current text of the UNCITRAL Arbitration Rules and noted that the question of whether the provision on the applicable version of the Rules should apply to agreements concluded before the adoption of the revised Rules was a matter to be further considered.

Model arbitration clause

“as at present in force”

39. The Working Group agreed that the words “as at present in force” should be considered for deletion if a provision referring to the applicable version of the Rules was adopted in article 1, paragraph (1) (see above, paragraphs 32-38).

Note to the model arbitration clause

Subparagraph (a)

40. A proposal was made to delete the reference in brackets to “person” for the reason that it was preferable to name institutions as appointing authorities, instead of individuals. While that proposal received some support, it was noted that removal of the possibility to appoint a person would run contrary to existing practice, including that of the Secretary-General of the Permanent Court of Arbitration who, in appropriate cases, appointed individuals as the appointing authority.

Subparagraph (c)

41. The Working Group noted that the question whether that subparagraph should refer to the term “seat” instead of “place” should be considered in the context of article 16 on the place of arbitration (see below, paragraphs 137-144). A proposal was made to delete the words “town or country” appearing in brackets since they did not express all factual possibilities and were not sufficiently flexible. In addition, naming a country alone as a place of arbitration left unclear the determination of the place of arbitration and, in cases where a country had more than one legal systems governing the arbitral procedure, the formulation did not take appropriate account of the fact that the designation of the location of the arbitration within that country could have significant legal consequences. However, it was pointed out that parties might need guidance on the meaning of the determination of the place of arbitration, and a proposal was made to retain those words, and replace “or” with “and”. The Working Group took note of those proposals.

Subparagraph (e)

42. The Working Group considered the proposal made at its forty-fifth session to add to the note to the model arbitration clause a reference to the law governing the arbitration agreement (A/CN.9/614, para. 37). Although that addition would have the benefit of raising awareness of the importance of defining the law applicable to the arbitration agreement, the widely shared view was that it would be misleading to retain it as it addressed only one aspect of the laws applicable in the context of arbitration. The Working Group considered whether the model arbitration clause should include a provision on the law applicable to the substance of the dispute, and whether the impact of the place of arbitration on the law applicable to the arbitral proceedings should also be clarified. The Working Group agreed that subparagraph (e) should not be retained and that the model arbitration clause should not contain any provision on applicable law.

Conciliation

43. The Working Group agreed that a reference to conciliation should not be added, in order to avoid unnecessarily complicating that model arbitration clause.

Notice, calculation of periods of time**Article 2***Paragraph (1)*

44. The Working Group proceeded to consider paragraph (1), which regulated when a notice, including a notification, communication or proposal could be deemed to have been received.

Deemed delivery of notice

45. The view was expressed that paragraph (1) should not be modified, for the reason that it had not created any difficulties in practice. It was also pointed out that article 2, paragraph (1) of the Rules was based on the 1974 UNCITRAL Convention on the Limitation Period in the International Sale of Goods and that a similar provision was contained in article 24 of the United Nations Convention on the Contracts for the International Sale of Goods (Vienna, 1980). It was said that

adoption of the proposed amendments could create unnecessary discrepancies among existing texts.

46. A suggestion was made to modify paragraph (1) to include a provision along the lines contained in article 3, paragraph 3 of the International Chamber of Commerce Arbitration Rules 1998 (“the ICC Rules”) which provided that: “A notification or communication shall be deemed to have been made on the day it was received by the party itself or by its representative, or would have been received if made in accordance with the preceding paragraph”. It was said that that modification would encompass situations where physical delivery of notices was not possible, for instance where an address provided was no longer in existence. The view was expressed that it was uncertain whether such situations would already be covered by the concept of “deemed receipt” of the notice by the defendant, as already contained in article 2, paragraph (1) of the Rules. However, it was indicated that, in the rules of other arbitration institutions, there were different provisions and that, in any case, delivery to the last known place of business or residence under article 2, paragraph (1), provided an adequate solution for such situations.

“Mailing address”

47. The Working Group considered whether the terms “mailing address” contained in article 2, paragraph (1), could be understood as including new means of communication, such as delivery of notices by e-mail. Broad support was expressed in the Working Group for deletion of the term “mailing”, so that the word “address” might be understood in a wider manner, as encompassing either a postal or electronic address.

Notice of arbitration

48. A question was raised whether the deemed delivery of notices should include delivery of the notice of arbitration. It was said that such a provision might deprive the defendant of a right to be properly notified of the commencement of the arbitration. To address that concern, a proposal was made to replace the notion of deemed receipt of notices, by the notion of proper service of notices. That proposal did not receive support.

49. After discussions, the Working Group agreed that paragraph (1) should not be amended as was proposed in document A/CN.9/WG.II/WP.145, but that any accompanying material should include clarification to deal with the situation where delivery was not possible.

Electronic communication — paragraph (1 bis)

50. The Working Group considered proposed new paragraph (1 bis) on delivery of notices by electronic means, as contained in document A/CN.9/WG.II/WP.145. Support was expressed for the view that the proposed new paragraph should include a reference to traditional ways of delivering notices, keeping in mind the importance of effectiveness of delivery, the necessity to keep a record of the issuance and receipt of notices, and the consent of the parties to the means of communication used. A proposal was made to add a provision along the following lines: “delivery pursuant to paragraph 1 may be made by facsimile, telex, e-mail or any other means of communication that provides a durable record of dispatch and receipt”. That proposal received some support. The Working Group agreed that the new provision on that question should contain the words “electronic communication” as these

words were used in the United Nations Convention on the Use of Electronic Communications in International Contracts (2005). The Working Group further agreed that these terms did not need to be defined, as definitions were already contained in the relevant UNCITRAL instruments. Caution was urged on the use of terms such as “durable records” which were not used in UNCITRAL instruments, and preference was expressed for the revised draft to be prepared being consistent with terminology used in the existing instruments. The Secretariat was requested to draft language for a paragraph (1 bis) that would authorize both electronic communication and traditional forms of communication.

Notice of arbitration and response to the notice of arbitration

Article 3

Paragraph (1)

Party [or parties]

51. The Working Group agreed that inclusion of the words “or parties” were useful to encompass multi-party arbitration and therefore should be retained.

Paragraph (3)

Subparagraph (b)

52. In order to take account of a suggestion that subparagraph (b), which required that the notice of arbitration contain the name and addresses of the parties, might also include additional contact details, the Working Group agreed to modify that subparagraph as follows: “(b) The names and contact details of the parties;”. For the sake of consistency, article 3, subparagraph (5)(b) should be modified so as to read: “the full name and contact details of any respondent” (see also below, paragraph 148).

Subparagraph (c)

53. It was said that subparagraph (c), which required identification of the arbitration agreement being invoked, might not provide sufficient information, particularly if the Rules were extended to apply to multi-party arbitration, and therefore it was suggested that subparagraph (c) be modified to provide that the notice of arbitration set out the actual wording of the arbitration agreement. No support was expressed for the suggestion.

Subparagraph (d)

54. It was suggested that the reference in subparagraph (d) to “any contract, or other legal instrument” ought to be made consistent with the earlier decision by the Working Group that disputes of a non-contractual nature would also be covered by the Rules (see above, paras. 21-24). For that reason, it was proposed to seek a broader formulation to encompass non-contractual disputes. That proposal received some support.

Mandatory items to be included in the notice of arbitration

55. The Working Group recalled its discussions at its forty-fifth session where it was cautioned that imposing an obligation to include too much information in the notice of arbitration might give rise to the question of how to deal with an

incomplete notice of arbitration, particularly in non-administered arbitration where no institution would oversee that issue (A/CN.9/614, para. 54). The Working Group agreed that it might be useful to address that issue in the revised Rules.

56. In that respect, a proposal was made to expressly provide that an incomplete notice of arbitration should not prevent the constitution of an arbitral tribunal and that the consequences of failing to include mandatory items in the notice of arbitration should be a matter to be determined by the arbitral tribunal. A proposal was made to add a provision along the following lines: “any controversy with respect to the sufficiency of the notice of arbitration shall be finally resolved by the arbitral tribunal, the constitution of which should not be impeded by such a controversy”. It was suggested that article 5.4 of the Arbitration Rules of the London Court of International Arbitration (LCIA) might provide a useful example on the question of the impact of an incomplete notice of arbitration, although the wording would need to be adapted for non-administered arbitration. It was also suggested that, in drafting a new provision, the Secretariat should consider whether the arbitral tribunal should be given express power to request rectification of a notice of arbitration so that, if the notice was rectified accordingly, the proceedings might, for the purposes of the relevant limitation period, be deemed to commence from the date that the notice was initially communicated. It was noted that rule 4.5 of the Australian Centre for International Commercial Arbitration Rules as well as the ICC Rules might provide useful models. The Working Group agreed to further consider that issue at a future session.

Paragraph (4)

Subparagraph (c)

57. The Working Group agreed that the option for the claimant to communicate its statement of claim should be retained. The Working Group agreed to further discuss at a future session whether the decision by the claimant that its notice of arbitration would constitute its statement of claim should be postponed until the stage of proceedings reflected in article 18.

Paragraph (5)

Mandatory or optional provision

58. The Working Group agreed that the provisions referred to in document A/CN.9/WG.II/WP.145, para. 39 on the response to the notice of arbitration should be maintained. Questions were raised whether the response to the notice of arbitration should be made optional. A suggestion was made to replace the words “which shall include” in the chapeau of paragraph (5) with the words “which may include”. The Working Group noted that paragraph (7) already contained provisions on the consequences of failure to communicate a response to the notice of arbitration. The Working Group agreed to further consider the wording of paragraphs (5) to (7) at a future session.

Time periods

59. It was observed that the thirty days time period for the communication of the response to the notice of arbitration might be too short in certain cases and did not appear to be synchronized with other time periods such as the fifteen day period for challenging an arbitrator as contained in article 11 of the Rules. The Working Group

agreed that there might be a need to revisit the various time periods provided in the Rules so as to ensure consistency.

Subparagraph (a)

60. A suggestion was made that the words “any comment” might not be appropriate if understood to preclude subsequent comment and that more precise language be used. The Working Group agreed to consider the drafting of paragraphs (5), (6) and (7) on the response to the notice of arbitration, at a later stage.

Investor-State arbitration

61. A view was expressed that specific provisions might need to be included to ensure transparency of the procedure for arbitration involving a State. Under that view, specific provisions should be included to deal with investor-State arbitration as follows: in article 3, a paragraph should be inserted to the effect that the notice of arbitration and the composition of the arbitral tribunal should be published on the UNCITRAL website; article 15, paragraph (3), should provide that all documents received or issued by the arbitral tribunal should be published by similar means; article 15, paragraph (4), should establish the discretion of the arbitral tribunal to allow persons or entities other than the parties to submit *amicus curiae* briefs; article 25, paragraph (4), should provide that hearings should be open to the public; and article 32, paragraph (5), should provide for the systematic publication of awards.

62. The Working Group recalled that, at its forty-fifth session, broad support had been expressed for a generic approach that sought to identify common denominators that applied to all types of arbitration irrespective of the subject matter of the dispute, in preference to dealing with specific situations (A/CN.9/614, paras. 18-19). The Working Group reiterated its support for that approach. It was recalled that, since practice in various areas, including in investor-State dispute settlement, was still developing, it would be undesirable to seek to design specific provisions at the current stage when the Working Group was still finalizing the common denominators that should be applied to all arbitrations. The Working Group agreed to revisit the issue after it had completed its first review of the revised provisions.

Representation and assistance

Article 4

“persons of their choice”

63. A proposal was made to replace the words “persons of their choice” appearing in the first sentence of article 4 with “persons chosen by them” in order to avoid the implication that the party had an unrestricted discretion, at any time during the proceedings, to impose the presence of any counsel (for example, a busy practitioner that would be unable to meet reasonable time schedules set by the arbitral tribunal). That proposal was broadly supported.

Existence/Scope of authority

64. The Working Group considered whether it would be useful to add language to article 4 to ensure that, when a person was empowered to represent a party,

disclosure should be made to any party or the arbitral tribunal of the content of its representative's powers. A question was raised whether such disclosure should be limited to the existence of the representative's powers or should also extend to the scope of the representative's authority.

65. It was said that requiring disclosure of the scope of authority might prove difficult in certain circumstances, as it could have the consequence of forcing disclosure of certain communications between the party and its representative that should be kept confidential, such as for example, a power to settle a claim at a certain amount.

66. It was suggested that the provision should be drafted in a flexible manner, allowing the arbitral tribunal to determine on its own motion the extent to which it needed to be provided with information on the scope of authority. In that respect, a proposal was made to add at the end of article 4, language along the following lines: "At any time, the arbitral tribunal may require from any party proof of authority granted to its representative in such a form as the arbitral tribunal may determine." It was said that the intention of that provision was not to deprive a party of its right to choose a representative but rather to confirm to the other party that a person was actually the representative of a party to the arbitration.

67. It was pointed out that, while the arbitral tribunal had the right to request a party to provide information on that question, it might be more useful to empower a party to request from the other communication of such information. Support was expressed for providing that such information should be communicated at the request of the arbitral tribunal, including at the instance of a party. As well, it was clarified that communication on proof of authority did not exclude communication on the scope of the representative's power.

"In writing"

68. The Working Group agreed to delete the words "in writing" in article 4, as the manner in which communication should be exchanged among the parties and the arbitral tribunal was already dealt with under article 2.

Designating and appointing authorities

Article 4 bis

69. The Working Group considered the provision referred to in document A/CN.9/WG.II/WP.145, paras. 41 and 42, and tentatively numbered article 4 bis, which was intended to deal with designating and appointing authorities. That provision contained the principle that the appointing authority could be appointed by the parties at any time during the arbitration proceedings, and not only in circumstances currently provided for in the Rules. It also sought to clarify for the users of the Rules the importance of the role of the appointing authority, particularly in the context of non-administered arbitration. The Working Group agreed on the principle of including in the Rules a provision addressing the respective roles of the designating and appointing authorities. Taking account of the simplification that resulted from the adoption of article 4 bis, the Secretariat was requested to review the Rules, assessing further possible simplification that could be made elsewhere in the Rules.

70. As a matter of drafting, it was proposed that, after insertion of a proper definition, the words "Secretary-General of the PCA" be used instead of the full title

“Secretary-General of the Permanent Court of Arbitration at The Hague”. Support was expressed for that proposal.

Paragraph (1)

71. The Working Group noted that the draft revision of paragraph (1) clarified that the Secretary-General of the PCA was expressly entitled to act as appointing authority under the Rules. A proposal was made to modify the draft text to provide that, where the parties were unable to agree on an appointing authority, the Secretary-General of the PCA should act directly as the appointing authority, instead of designating an appointing authority. It was said that such a provision would preserve the freedom of the parties to select any other appointing authority but provide more predictability in the event they did not agree.

72. Concerns were expressed that that proposal would not sufficiently take account of the multi-regional applicability of the UNCITRAL Arbitration Rules, and would have the consequence of centralizing all cases where the parties had not designated an appointing authority in the hands of one organization. While the view was expressed that such a provision might be appropriate for investor-State disputes, a widely held opinion was that it would not be as appropriate in other instances. Reference was made to regional and domestic arbitration. It was said that the mechanism provided in the original version of the Rules was functioning well, and did not need to be modified. With a view to accommodating these concerns, the proposal was amended to provide that the parties should retain the right to request the Secretary-General of the PCA to appoint another appointing authority, and that the Secretary-General of the PCA itself should be empowered to designate another appointing authority, if it considered it appropriate.

73. In support of that proposal, it was recalled that the PCA was a unique intergovernmental organization with broad membership. It was said that the proposal would preserve the right of the parties to designate an appointing authority. It was also stated that, in expressing a default rule, the proposal provided the parties with a simple, streamlined and efficient procedure. In the context of that discussion, the Working Group recognized the expertise and the accountability of the PCA, as well as the quality of the services it rendered under the UNCITRAL Arbitration Rules.

74. The prevailing view, however, was the proposal constituted a major and unnecessary departure from the existing UNCITRAL Arbitration Rules. After discussion, it was decided that, with the amendments to article 4 bis as proposed in document A/CN.9/WG.II/WP.145, the existing mechanism on the designating and appointing authority should be preserved. The Working Group noted that the representative of the Permanent Court of Arbitration confirmed the agreement of its Secretary-General to perform the functions provided for in the draft revised Rules.

Paragraph (2)

75. In order to clarify the principle that the designation of the appointing authority could be sought by the parties at any time during the arbitration proceedings, the Working Group agreed to add the words “with the Notice of Arbitration or any time thereafter” after “any party” so that that part of the sentence read: “any party, with the Notice of Arbitration or any time thereafter, may request the Secretary-General of the Permanent Court of Arbitration at The Hague to designate an appointing authority.” That proposal was adopted.

Paragraph (3)

76. The Working Group agreed that paragraph (3) should include a general principle that the parties should be given an opportunity to be heard by the appointing authority.

Paragraph (5)

77. The Working Group agreed that the words “the name of one or more” appearing in the last sentence of paragraph (5) should be deleted.

78. The Working Group agreed that paragraph (5) should clarify that it was for the proposed arbitrators (rather than the appointing authority) to provide information regarding their qualifications to the parties.

Section II. Composition of the arbitral tribunal

Number of arbitrators — Article 5

Paragraph (1)

79. The Working Group recalled that, at its forty-fifth session, diverging views were expressed on whether the default rule on the number of arbitrators should be modified (A/CN.9/614, paras. 59-60). It proceeded to consider the various options referred to in document A/CN.9/WG.II/WP.145, paras. 43 and 44 on that question.

Option 1, variant 1 and option 2

80. Preference was expressed for option 1, variant 1, which provided that if the parties were unable to agree on the appointment of one arbitrator, three arbitrators should be appointed. It was said that that option most closely reflected the current default rule set out in article 5. Option 2 provided that, if the parties were unable to agree on the number of arbitrators, that matter should be determined by the appointing authority. That option received limited support for the reason that involving an appointing authority at such an early stage of the arbitral proceeding could create unnecessary delays.

Alternative proposal

81. An alternative proposal was made to include text along the following lines: “If the parties have not previously agreed on the number of arbitrators, one arbitrator shall be appointed, unless either the claimant in its notice of arbitration or the respondent, by the time for filing the response to the notice of arbitration, requests that there be three, in which case there shall be three arbitrators.” It was suggested that that approach avoided imposing a three-person tribunal in arbitration involving small claims. The substance of that proposal received support as it included an additional level of flexibility. However, it was suggested that the drafting should be revised. It was also suggested that the fifteen day period granted to the respondent to request the appointment of three arbitrators might be too short, particularly in arbitrations involving State parties. In that respect, it was suggested to replace “within fifteen days” either by “within thirty days”, as provided for in respect of the response to the notice of arbitration or “within the time period for responding to the notice of arbitration”.

82. The Working Group agreed to further consider the matter and requested the Secretariat to provide revised drafts reflecting the alternative proposal.

Paragraph (2)

83. The Working Group expressed support for draft paragraph (2), as contained in document A/CN.9/WG.II/WP.145. That paragraph clarified that the Rules provided for methods to form either a one or a three-member arbitral tribunal and if the parties wished to opt for another number (e.g., to have a two-member arbitral tribunal, which was allowed by the UNCITRAL Arbitration Model Law and was customary in some trades), the parties should define their own method for the constitution of the arbitral tribunal. It was noted that paragraph (2) did not contain a fallback rule and a suggestion was made that, in such situations, the appointing authority might need to be involved.

Appointment of arbitrators (articles 6 to 8)

Article 6

84. The Working Group adopted article 6 in substance, as contained in A/CN.9/WG.II/WP.145.

Article 7

85. The Working Group adopted article 7 in substance, as contained in A/CN.9/WG.II/WP.145.

Article 7 bis

Appointment of arbitrators in multi-party arbitration — Principle

86. The Working Group recalled that article 7 bis, as referred to in document A/CN.9/WG.II/WP.145, para. 47, had been inserted to deal with the appointment of arbitrators in multi-party cases, in accordance with its discussions at its forty-fifth session (A/CN.9/614, paras. 62 and 63). General support was expressed for the principle contained in article 7 bis that, in case of multiple claimants or respondents, subject to contrary agreement, the multiple claimants, jointly, and the multiple respondents, jointly should appoint an arbitrator. It was suggested that the article should be drafted broadly enough to encompass situations where one side involved multiple parties whilst the other had only one party.

Paragraph (1)

87. A proposal was made to add the word “each” or “each group” after the word “shall” in the first sentence of paragraph (1) to indicate that the multiple claimants on one part and the multiple respondents on the other would each appoint an arbitrator. Another proposal was that, in the second sentence of paragraph (1), the words “shall choose” should be replaced by more flexible wording along the lines of “shall endeavour to choose”. Those proposals were adopted.

Paragraph (2)

Failure to constitute the arbitral tribunal

88. A suggestion was made that the words “In the event of a failure to constitute the arbitral tribunal” should replace the current opening words “In the absence of

appointment pursuant to paragraph 1” for the reason that the power of the appointing authority to constitute the arbitral tribunal should be more broadly formulated to cover all possible failures to constitute the arbitral tribunal and not be limited to those circumstances covered by paragraph (1). That proposal was adopted.

Discretionary right of the appointing authority — Revocation of appointments already made

89. It was questioned whether the discretionary term “may” in relation to power of the appointing authority to constitute the arbitral tribunal at the request of a party was appropriate. Concern was expressed that, as drafted, paragraph (2) appeared to permit the appointing authority, in case of failure to appoint arbitrators, to constitute the arbitral tribunal and revoke appointments already made. It was suggested that that approach might bear the consequence of depriving parties of the right to appoint their own arbitrator and give the multiple parties who failed to appoint an arbitrator the ability to cause all arbitrators to be appointed anew by the appointing authority.

90. Support was expressed for maintaining the principle in paragraph (2) permitting the appointing authority to constitute the arbitral tribunal, including the right to revoke already appointed arbitrators. It was said that the principle in paragraph (2) that the appointing authority should appoint the entire arbitral tribunal when parties on the same side in a multi-party arbitration were unable jointly to agree on an arbitrator was an important principle that should be maintained, in particular in situations like the one which had given rise to the case *Dutco v. BKMI and Siemens*, which had led to revisions of a number of international arbitral rules, including the ICC Rules (Article 10) and the LCIA Arbitration Rules (Article 8.1). It was stated that the decision in *Dutco* was based on the requirement that parties receive equal treatment, a principle that would apply in all countries bound by article 6 of the European Convention on the Protection of Human Rights and Fundamental Freedoms, as well as in many other jurisdictions. It was also stated that, to accommodate the wide variety of situations arising in practice, it was important to maintain a flexible approach, granting discretionary powers to the appointing authority.

91. A widely held view was that the right of parties to appoint their arbitrator should nevertheless be preserved and, in order to clarify that the appointing authority was unambiguously entitled to reappoint an arbitrator agreed upon by one side, the Working Group discussed whether the mechanism of designation by the parties of arbitrators under the Rules should be modified, so as to provide a two-step procedure. According to a proposal made to that effect, a distinction should be made between the stage when parties would nominate their arbitrator and the stage when the arbitrator would be appointed. It was widely felt that such a two-step procedure, while consistent with the rules of a number of arbitral institutions, might lead to unnecessary modifications in the current provisions of the Rules dealing with appointment and revocation of arbitrators. It was suggested that the issue could be settled more simply by inserting the words “or reappoint” after the word “appoint” in paragraph (2) and deleting the reference to the confirmation of an appointment. That proposal received support, and the Working Group agreed to further consider the matter at a future session.

Right of the parties to be heard by the appointing authority

92. It was further suggested that paragraph (2) should expressly recognize the right of all parties to be heard by the appointing authority on the question of constitution of the arbitral tribunal (see above, paragraph 76). That proposal received support.

Time limit

93. It was suggested that time limits could be defined under paragraph (2). The Working Group agreed to further consider that matter at a later stage.

Article 8

94. The Working Group agreed to the deletion of article 8, the substance of which had been placed in article 4 bis on the designating and appointing authorities.

Challenge of arbitrators (Articles 9 to 12)**Article 9**

95. The Working Group adopted article 9 in substance, as contained in A/CN.9/WG.II/WP.145.

Model Statement of Independence

96. The Working Group considered whether guidance should be provided in the Rules on the required content of disclosure, in the form, for instance of a model statement of independence attached as a footnote to article 9 or in any accompanying material and in the form set out in paragraph 50 of A/CN.9/WG.II/WP.145.

97. Concern was expressed that the language used in the two statements differed. It was suggested that, to ensure equivalence between the statements, the words “there are no circumstances, past or present likely to give rise to justifiable doubts as to my impartiality” in the first statement be replaced by words such as “I have no past and present professional, business and other relationships with the parties and there are no other circumstances that might cause my reliability for independent and impartial judgement to be questioned by a party.” It was noted that the language contained in the model statement corresponded with the IBA Rules of Ethics for International Arbitrators (1987). It was noted that the Model Statement of Independence was intended to be contained in the revised Rules as a footnote to article 9.

98. A suggestion was made that the point in time when the arbitrator should provide a statement should be clarified. That suggestion did not receive support.

99. After discussion, the Working Group agreed to adopt in substance the text of the Model Statement of Independence, as contained in A/CN.9/WG.II/WP.145.

Article 10

100. The Working Group adopted the text of article 10 as contained in A/CN.9/WG.II/WP.145.

Article 11

101. The Working Group adopted the text of article 11 as contained in A/CN.9/WG.II/WP.145.

Article 12*Paragraph (1)**Time limits for challenge*

102. A suggestion was made that the time limits provided under paragraph (1) might need to be shortened. After discussion, it was agreed that if, within 15 days from the date of the notice of challenge, any other party did not agree to the challenge and the challenged arbitrator did not withdraw, the party making the challenge could seek a decision on the challenge within thirty days rather than sixty.

Paragraph (2)

103. The Working Group noted that the modified text in paragraph (2) permitted the appointing authority directly to appoint an arbitrator if it considered that the circumstances of the arbitration were such that a party should be deprived of its right to appoint a replacement arbitrator.

104. A proposal was made that that power should be limited to cases where a party had abused the challenge procedure repeatedly. That proposal was objected to on the grounds that the circumstances in which an appointing authority might proceed directly to appoint an arbitrator might extend to various other circumstances. It was thus preferable to formulate the power of the appointing authority in more general terms.

105. The Working Group agreed to maintain the text in general terms but requested the Secretariat to consider preparing, for possible inclusion in any explanatory material, an illustrative list of possible circumstances in which the appointing authority could exercise its power under paragraph (2).

Replacement of an arbitrator**Article 13***Paragraph (1)*

106. The Working Group approved the substance of paragraph (1), as contained in A/CN.9/WG.II/WP.145.

Paragraph (2)

107. The Working Group noted that paragraph (2) provided two different ways for an appointing authority to deal with an unapproved resignation of an arbitrator or failure by an arbitrator to perform his or her functions, being either to appoint directly a substitute arbitrator or allow the proceedings to continue without a substitute arbitrator (A/CN.9/614, para. 70).

108. Concern was expressed with the wording “a party considers that an arbitrator has resigned for invalid reasons or is failing to perform his or her functions”. It was suggested that the original text which referred to an arbitrator who “refuses or fails

to act” was preferable to “failing to perform his or her functions”. That suggestion received support.

109. The Working Group also considered whether there were circumstances in which the arbitrators themselves, rather than just a party, should be given the power either to decide to proceed as a truncated tribunal or seek approval from the appointing authority for so proceeding. Support was expressed for that suggestion as it would encompass situations where an arbitrator was failing to act and none of the parties were aware of that fact. However, it was said that granting the power to the arbitral tribunal to proceed as a truncated tribunal might not provide sufficient safeguards for the parties, in particular in case of collusion between arbitrators. As well, it was said that allowing the arbitral tribunal to seek approval of the appointing authority might be problematic in cases where the parties had not chosen such an appointing authority. It was said that that difficulty could be overcome by providing that the arbitral tribunal should in such cases refer the matter to the parties, who would then proceed with the designation of an appointing authority. It was suggested that a time limit should be introduced for parties to raise objections to an inactive arbitrator.

110. A suggestion was made that the arbitral tribunal should in all cases be involved in the process of replacement of an arbitrator.

111. A view was expressed that the provision on replacement of arbitrators should clearly distinguish the revocation of an arbitrator who failed to act from the resignation of an arbitrator for invalid reasons. It was said that those two circumstances had to be subject to different procedures as each might have different consequences in terms of liability.

112. After discussion, the Working Group requested the Secretariat to prepare alternative formulations, taking account of the suggestions made.

Repetition of hearings in the event of the replacement of an arbitrator

Article 14

113. The Working Group adopted the text of article 14 in substance, as contained in A/CN.9/WG.II/WP.145.

Section III. Arbitral proceedings

General provisions — Article 15

Paragraph (1)

114. The Working Group considered the provision in paragraph (1), which spelled out the general principle that arbitral proceedings should be dealt with by the arbitral tribunal without unnecessary delay. A proposal was made to include an express provision conferring on the arbitral tribunal the power to hold preliminary consultations or meetings either at the request of the parties or at its own initiative. That proposal did not receive support, and the Working Group adopted the substance of paragraph (1), as it appeared in document A/CN.9/WG.II/WP.145/Add.1.

Paragraphs (2) and (3)

115. Paragraphs (2) and (3) were adopted in substance without modification.

*Paragraph (4)**Consolidation of cases before arbitral tribunals*

116. The Working Group noted that, in some cases, under the Rules, consolidation of cases was only possible where the parties specifically so agreed and proceeded to consider whether a provision on that matter should be added to the Rules, as proposed under document A/CN.9/WG.II/WP.145/Add.1.

117. Some support was expressed for inclusion of such a provision. It was said that such a provision could be useful in situations where several distinct disputes arose between the same parties under separate contracts (e.g., related contracts or a chain of contracts) containing separate arbitration clauses or to avoid a situation where a party initiated a separate arbitration in respect of a distinct claim under the same contract in order to gain a tactical advantage. Consolidation in such situations might provide an efficient resolution of the disputes between the parties, and also might reduce the possibility of inconsistent awards in parallel arbitrations.

118. It was said however that such a provision should be carefully drafted in order to clarify that consolidation would only be possible if either the claim was already subject to UNCITRAL Arbitration Rules, or the parties expressly agreed that the claim should be subject to consolidation.

119. However, doubts were expressed as to the workability of such a provision particularly when the Rules applied in non-administered cases. As well, it was said that either the provision was intended to deal with new claims under the same contract, and that situation would be better dealt with under provisions on amendment of the statement of claim, or that provision was intended to cover several distinct disputes arising between the same parties under separate contracts containing separate arbitration clauses. In that latter situation, the application of the provision might subject parties to arbitration proceedings under terms, which differed from those, agreed in their arbitration agreement. It was said that that situation raised complex issues, and might result in unfair solutions.

120. After discussion, the Working Group agreed that it might not be necessary to provide for consolidation under the Rules and deleted subparagraph (a) (see below, paragraphs 157-160).

Joinder

121. The Working Group considered a proposed provision on joinder, as it appeared in document A/CN.9/WG.II/WP.145/Add.1, and noted that the provision was inspired by article 22.1 (h) of the LCIA Arbitration Rules, which provided that the arbitral tribunal could: “allow, only upon the application of a party, one or more third persons to be joined in the arbitration as a party provided any such third person and the applicant party have consented thereto in writing, and thereafter to make a single final award, or separate awards, in respect of all parties so implicated in the arbitration”.

122. Some support was expressed for inclusion of such a principle in the Rules, as it was said to fulfil the useful purpose of allowing interested third parties to join an arbitration in circumstances where the other party objected to such joinder.

However, concerns were expressed that such a provision would run counter to the fundamental principle of consent of parties in arbitration, and that such a provision would be acceptable only if it either contained an opt-in or opt-out proviso or if it were modified so that joinder would only be possible if all parties to the arbitration agreed thereto. It was pointed out that securing agreement of all parties would avoid possible difficulties at the stage of recognition and enforcement of the arbitral award, as it would put the agreement of all parties to the arbitration beyond doubt. In response, it was said that, as parties to arbitration always retained the right to agree on joinder without the need for a specific provision to that effect, requiring consent of all the parties would render the provision unnecessary. It was also noted that, insofar as parties agreed to arbitration under Rules containing the proposed joinder provision, they would have consented to the voluntary joinder of a third party.

123. It was suggested that the provision should clarify that the third party should in the first place agree to be joined in the arbitration, as was provided for under article 22.1 (h) of the LCIA Arbitration Rules.

124. A question was raised whether that provision should clarify on which side the third party should join the arbitration. In response, it was said that the provision might need to remain as flexible as possible to accommodate the varying circumstances in which a third party might seek joinder.

125. A suggestion was made to delete the reference to the making of an award in respect of all parties involved in the arbitration. It was observed that if the third party joined as a party, then there might be no need for such a provision. It was considered preferable to retain a reference to the making of the award, in order to put beyond doubt that the arbitration would be binding on all parties, whether they were the original parties to the arbitration or joined later in the process. As well, it was said that such an express provision in the Rules might serve a useful purpose at the stage of recognition and enforcement of the arbitral award.

126. After discussion, the Working Group agreed that the provision on joinder would constitute a major modification to the Rules, and noted the diverging views, which were expressed on that matter. The Working Group agreed to consider that matter at a future session, on the basis of information to be provided by arbitral institutions to the Secretariat on the frequency and practical relevance of joinder in arbitration.

Confidentiality of proceedings

127. The Working Group considered whether it would be appropriate to include a general provision regarding confidentiality of proceedings, or of the materials (including pleadings) before the arbitral tribunal. The Working Group recalled that, at its forty-fifth session, many delegations expressed the opinion that a general confidentiality provision should not be included. It was also suggested that the matter should be left to be addressed on a case-by-case basis by the arbitrators and the parties (A/CN.9/614, para. 86).

128. Some support was expressed for inclusion of a general provision regarding confidentiality, particularly in light of decisions such as that of the English Court of Appeal in *City of Moscow v. Bankers Trust*, which was said to highlight the importance of including a provision in the Rules. It was said that a number of existing international arbitral rules such as the LCIA Arbitration Rules and WIPO rules contained specific provisions on confidentiality. The attention of the Working

Group was drawn to article 9 of the UNCITRAL Model Law on International Commercial Conciliation as a possible reference for drafting a provision on confidentiality.

129. However, it was cautioned that drafting a general provision on confidentiality would be extremely problematic, since it would require addressing questions such as when the duty of confidentiality arose and ended, whether that duty extended to persons other than the parties, such as witnesses or experts, and what exceptions should be made to that duty.

130. Against inclusion of a general provision of confidentiality, it was suggested that inclusion of such a general provision would run counter to the current trend toward greater transparency in international proceedings. It was also said that the underlying aim of the revision of the Rules was to provide flexibility so as to accommodate evolving law and practices. In that respect, it was noted that confidentiality was an area where law and practices were still developing.

131. In addition, drafting a general provision on confidentiality might not be appropriate in view of the fact that the importance of confidentiality in any given arbitration would depend on the nature of the relationship in question. For example, contracts relating to intellectual property demanded a high degree of confidentiality. For these reasons, it was suggested that the question of confidentiality be left to be addressed by the arbitrators and the parties on a case-by-case basis.

132. A concern was expressed that there might be a large number of users of the Rules who expected the Rules to guarantee confidentiality. To address that concern, a suggestion was made to include a footnote to the model arbitration clause appended to article 1 of the Rules drawing the parties' attention to the possibility of adding a provision on confidentiality including its scope, duration and to whom the duty was addressed. It was said that such a footnote could serve as a reminder that the matter was one which the parties needed to address and was not dealt with in the Rules.

133. After discussion, the Working Group agreed that no provision on confidentiality of proceedings should be included in the Rules.

Extend or shorten time periods

134. The Working Group recalled that a proposal had been made at its forty-fifth session to include in the Rules a general provision in article 15, along the lines of "In discharge of its duties under article 15, paragraph (1), the arbitral tribunal may at any time extend or abridge any period of time prescribed under or pursuant to the Rules" (A/CN.9/614, paras. 41-46).

135. While various views were stated as to whether the arbitral tribunal had an inherent power to change procedural time limits, support was expressed for expressly dealing with that matter in the Rules. However, concern was expressed that it might be inappropriate to permit the arbitral tribunal to modify the parties' agreement, for example an agreement that the arbitration should be completed within a certain period of time. A suggestion was made the arbitral tribunal should be required to provide reasons justifying any change to the procedural time periods, in line with the approach taken in article 23 of the Rules. That proposal was not supported. A question was raised as to any power given to the arbitral tribunal to extend time-limits should also be given to the appointing authority pending the constitution of the arbitral tribunal. It was pointed out that conferring such power on

the arbitral tribunal could create a risk of delaying the constitution of the arbitral tribunal.

136. After discussion, the Working Group agreed that the Rules should establish the authority of the arbitral tribunal to modify the periods of time prescribed in the Rules but not to alter the general time frames that might be set by the parties in their agreements without prior consultation with the parties.

Article 16

Place of arbitration

137. The Working Group considered whether to include terminology differentiating between the “seat of arbitration” (when referring to the legal place of arbitration that determined the applicability of the law governing the arbitration as well as court jurisdiction) and “location” or “venue” (when referring to the place where meetings were actually held). The Working Group also considered whether specific language should be added to article 16 regarding the consequences attaching to the legal place of arbitration.

Use of differentiated terminology

138. It was suggested that it might be necessary to distinguish between the legal and physical places of arbitration, and that modification of the terminology used would promote clarity. It was observed that the modification might also serve an educational purpose, given that users were often unaware of the legal consequences that attached to the term “place of arbitration”. Diverging views were expressed as to how best to achieve distinction between the legal and physical places of arbitration.

139. A proposal was made to replace the words “place of arbitration” in article 16, paragraphs (1) and (4) with words such as the “seat”, “legal seat” or “juridical seat” of arbitration. It was proposed that a term such as “location” be used when dealing with the purely physical or geographical place of arbitration, under paragraphs (2) and (3).

140. Another proposal was made that article 16 might be amended along the lines of article 16 of the LCIA Arbitration Rules, which referred in its paragraph (1) to the “the seat (or legal place)” of the arbitration, and which provided under its paragraph (2) that “the Arbitral Tribunal may hold hearings, meetings and deliberations at any convenient geographical place in its discretion and, if elsewhere than the seat of the arbitration, the arbitration shall be treated as an arbitration conducted at the seat of the arbitration (...)”. That proposal received some support.

141. However, it was cautioned that the use of new terminology might lead to unintended consequences to existing contractual drafting practices that used different expressions, including the “place of arbitration”, with the intention of referring to the legal seat of arbitration. In response, it was said that the word “place” had a generic connotation that could encompass either the legal or physical place depending on the context in which it was used. The Working Group further considered but did not reach a conclusion as to whether the Rules should remain consistent with the UNCITRAL Arbitration Model Law (which currently used the expression “place of arbitration”) or whether a different terminology should be used.

142. In order to clarify that matter, proposals were made to restructure article 16 by merging paragraphs (1) and (4) (which dealt with the legal place of arbitration) and paragraphs (2) and (3) (which dealt with the physical place of arbitration). As well, it was proposed to relocate paragraph (4) under article 32 of the Rules, which dealt with awards.

Consequences arising from the legal place of arbitration

143. A question was raised whether paragraph (1) should clarify that the legal place of arbitration determined the law applicable to the arbitral procedure and court jurisdiction. After discussion, the Working Group agreed that the legal consequences arising from the choice of a seat of arbitration might differ in different legal systems, and that the Rules were not the appropriate instrument to codify that matter.

144. After discussions, the Working Group agreed to further consider that matter at a future session, and requested that the Secretariat provide alternative drafts, based on the discussion in the Working Group. It was agreed that attention should be given to further distinguishing hearings and other meetings held with the parties from meetings held exclusively for the tribunal's deliberations.

Language

Article 17

145. The Working Group agreed to delete the reference to “or languages” in article 17 (as well as in the note to the Model Arbitration Clause) on the basis that, in situations where more than one language was required to be used in arbitral proceeding, the parties were free to agree upon that.

Statement of claim — Article 18

Paragraph (1)

146. A question was raised whether the reference to “a copy of the contract and of the arbitration agreement” was still needed in light of the Working Group's earlier considerations in respect of whether or not to retain the writing requirement (see above, paragraphs 25-31). The view was expressed that, where a written contract and arbitration agreement existed, the obligation to communicate a copy needed to be maintained.

147. After discussion, the Working Group agreed that the drafting of the provision on the communication of the contract and arbitration agreement under articles 3 and 18 should be aligned. A further suggestion was made to simplify that sentence by deleting the words “if not contained in the contract”. That proposal generally supported. The Working Group requested the Secretariat to revise these provisions accordingly.

Paragraph (2)

Subparagraph (a)

148. A suggestion was made that the reference to “addresses of the parties” could be revised in accordance with the earlier discussions of the Working Group concerning article 3, paragraphs (3)(b) and (5)(b) to replace the word “addresses” by the words “contact details” (see above, paragraph 52). That proposal was adopted.

Subparagraph (b)

149. The Working Group considered whether paragraph (2)(b) should be reformulated to read “a statement of the facts and legal principles supporting the claim” in order to encourage the parties to substantiate their claims from a legal point of view. Concern was expressed that the words “legal principles” were too vague and suggestions were made to replace those words with words such as “legal arguments” or “legal grounds”.

150. It was suggested that the proposed change was unnecessary as it would eliminate the existing flexibility in that provision and would not accommodate the various practices that existed in different legal systems. In response, it was said that the fact that there were differing legal practices underscored the importance of addressing that issue in the Rules. Strong support was expressed for adding a reference to the “legal grounds”.

151. After discussion, the Working Group agreed to add a new subparagraph (e) providing that the statement of claim should include a reference to the legal arguments or grounds supporting the claim.

Last sentence of paragraph (2)

152. Support was expressed for the proposal that the last sentence of article 18 (2) be reworded along the following lines: “The statement of claim shall, as far as possible, be accompanied by all documents and other evidentiary materials relied upon by the claimant or by references to them.”

153. Concern was expressed that the use of the word “shall” suggested that the claimant would be obliged to communicate a comprehensive statement of claimant and would be precluded from providing subsequent materials. To address that concern, it was suggested that the word “shall” be replaced by “should” in order to establish a standard for the contents of the statement of claim without imposing rigid consequences for departures from that standard.

154. After discussion, the Working Group requested the Secretariat to prepare a revised text taking account of the discussion.

Statement of claim in multi-party arbitration

155. The Working Group agreed that it was not necessary to amend article 18 to address the question of statement of claim in multi-party arbitration.

Statement of defence**Article 19**

156. The Working Group agreed that, where applicable, the drafting of article 19 should be aligned with the revisions adopted in respect of article 18.

Raising claims for the purpose of set-off and counter-claims

157. The Working Group agreed that article 19 should contain a provision on set-off and that the arbitral tribunal’s competence to consider counter-claims or set-off should, under certain conditions, extend beyond the contract from which the principal claim arose and apply to a wider range of circumstances. To achieve that extension, the revised provision as contained in

document A/CN.9/WG.II/WP145/Add.1 replaced the words “arising out of the same contract” with the words “arising out of the same legal relationship, whether contractual or not”. Some support was expressed for that proposal.

158. A suggestion was made that the provision should be modified so as to allow counter-claims that were substantially connected to (or arose out of) the initial claim. Another suggestion was either to omit the words “arising out of the same legal relationship, whether contractual or not” or that the provision should not require that there be a connection between the claim and the counter-claim or set-off, leaving to the arbitral tribunal the discretion to decide that question. In that context, the view was expressed that removal of any connection between the claim and the counter-claim or set-off might accommodate the needs of specific situations such as investment disputes involving States but might not sufficiently meet the needs of more general commercial disputes.

159. It was suggested that articles 3 (6)(d), 15 (4)(a), 19 (3), and 28 (1) should consistently refer to “counter-claims or claims for the purpose of a set-off.”

160. After discussion, the Working Group agreed that the present wording of article 19 was too narrow and requested the Secretariat to prepare alternative versions taking account of the discussions on that matter, including through a possible revision of article 15 on consolidation.

Amendments to the claim or defence

Article 20

161. The Working Group agreed to adopt article 20 in substance, as contained in A/CN.9/WG.II/WP.145.

Pleas as to jurisdiction of the arbitral tribunal

Article 21

Paragraph (1)

162. In the interests of simplicity, the Working Group agreed to replace the words “ipso jure” with wording as along the lines of “of itself”.

Paragraph (2)

163. The Working Group adopted paragraph (2) in substance, as contained in A/CN.9/WG.II/WP.145.

Paragraph (3)

164. The Working Group noted that paragraph (3) had been revised so as to be consistent with article 16, paragraph (3) of the UNCITRAL Arbitration Model Law, in accordance with the Working Group discussions at its forty-fifth session. A suggestion was made that the provision should allow the parties to request the arbitral tribunal to rule on its jurisdiction as a preliminary question. A question was raised whether the provision should encompass any pending dispute before a court on the arbitration. The Working Group agreed to further consider that matter.

**D. Note by the Secretariat on settlement of commercial disputes:
Revision of the UNCITRAL Arbitration Rules, submitted to the
Working Group on Arbitration at its forty-sixth session
(A/CN.9/WG.II/WP.145 and Add.1) [Original: English]**

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Introduction

1. At its thirty-ninth session (New York, 19 June-7 July 2006), the Commission agreed that, in respect of future work of the Working Group, priority be given to a revision of the UNCITRAL Arbitration Rules (1976) (“the UNCITRAL Arbitration Rules” or “the Rules”).¹ The Commission previously discussed that matter at its thirty-sixth (Vienna, 30 June-11 July 2003), thirty-seventh (New York, 14-25 June 2004) and thirty-eighth (Vienna, 4-15 July 2005) sessions.²

2. At its forty-fifth session (Vienna, 11-15 September 2006), the Working Group undertook to identify areas where a revision of the UNCITRAL Arbitration Rules might be useful. At that session, the Working Group gave preliminary indications as to various options to be considered in relation to proposed revisions, on the basis of documents A/CN.9/WG.II/WP.143 and Add.1, in order to allow the Secretariat to prepare a draft of revised Rules taking account of such indications.

3. This note contains an annotated draft of revised UNCITRAL Arbitration Rules, based on the deliberations of the Working Group at its forty-fifth session and covers articles 1 to 14 of the UNCITRAL Arbitration Rules. Articles 15 to 41 are dealt with under A/CN.9/WG.II/WP.145/Add.1. All references to discussions and considerations

¹ *Official Records of the General Assembly, Sixty-first Session, Supplement No. 17* (A/61/17), paras. 182-187.

² *Ibid.*, *Fifty-eighth Session, Supplement No. 17* (A/58/17), para. 204; *ibid.*, *Fifty-ninth Session, Supplement No. 17* (A/59/17), para. 60; *ibid.*, *Sixtieth Session, Supplement No. 17* (A/60/17), para. 178.

by the Working Group in the note are to discussions and considerations made at the forty-fifth session of the Working Group.

1. General remarks

Principles to be applied in revising the UNCITRAL Arbitration Rules

4. It is recalled that, at the thirty-ninth session of the Commission (New York, 19 June-7 July 2006), in recognition of the success and status of the UNCITRAL Arbitration Rules, the Commission was generally of the view that any revision of the UNCITRAL Arbitration Rules should not alter the structure of the text, its spirit, its drafting style, and should respect the flexibility of the text rather than make it more complex.³

5. At its forty-fifth session (Vienna, 11-15 September 2006), the Working Group agreed that the UNCITRAL Arbitration Rules had been one of the most successful instruments of UNCITRAL and therefore cautioned against any unnecessary amendments or statements being included in the travaux préparatoires that would call into question the legitimacy of prior applications of the Rules in specific cases. It was considered that the focus of the revision should be on updating the Rules to meet changes that had taken place over the last thirty years in arbitral practice (A/CN.9/614, para. 16). It is further recalled that broad support was expressed for a generic approach that sought to identify common denominators that applied to all types of arbitration irrespective of the subject matter of the dispute, in preference to dealing with specific situations (A/CN.9/614, para. 18).

Harmonization of the drafting of the UNCITRAL Arbitration Rules with the UNCITRAL Model Law on International Commercial Arbitration ("Model Law")

6. The Working Group agreed that harmonizing the provisions of the UNCITRAL Arbitration Rules with the corresponding provisions of the Model Law should not be automatic but rather considered only where appropriate (A/CN.9/614, para. 21).

General remark on the reference to "parties" in the Rules

7. Amendments have been proposed in the text of the Rules to replace words such as "both parties", "either party", "one of the parties" with more generic formulation, so as to encompass multi-party arbitration.

2. Notes on a draft of revised UNCITRAL Arbitration Rules

8. All suggested modifications to the UNCITRAL Arbitration Rules are marked up in the text below.

Section I. Introductory rules

[Scope of application] [Applicability]

Article 1

1. *Option 1:* [Where ~~the parties to a contract~~ have agreed [in writing*] that disputes between them in relation to that contract [in respect of a defined legal relationship, whether contractual or not] shall

³ Ibid., *Sixty-first Session, Supplement No. 17* (A/61/17), para. 184.

be referred to arbitration under the UNCITRAL Arbitration Rules, then such disputes shall be settled in accordance with these Rules] *[include text from Variants 1, 2 or 3]*

Option 2: [Where there is an agreement [in writing*] to refer disputes to arbitration under the UNCITRAL Arbitration Rules, then such disputes shall be settled in accordance with these Rules] *[include text from Variants 1, 2 or 3]*

Variant 1: [subject to such modification as the parties may agree [in writing].]

Variant 2: [as in effect on the date of commencement of the arbitration, subject to such modification as the parties may agree [in writing].]

Variant 3: [subject to such modification as the parties may agree [in writing]. Unless the parties have agreed to apply the Rules as in effect on the date of their agreement, the parties shall be deemed to have submitted to the Rules in effect on the date of commencement of the arbitration.]

2. These Rules shall govern the arbitration except that where any of these Rules is in conflict with a provision of the law applicable to the arbitration from which the parties cannot derogate, that provision shall prevail.

Remarks

Title

9. The Working Group might wish to consider whether the title of article 1 should read “Applicability” instead of “Scope of application”, given that article 1 contains provisions on the principles of application of the Rules and is not limited to matters relating to the scope of application.

Paragraph (1)

Options 1 and 2

“parties to a contract”

10. Option 1 most closely corresponds to the current version of the Rules, by including a reference to “parties”, whereas option 2 implements a suggestion made in the Working Group to delete any reference to “parties” in the opening words of article 1, paragraph (1) (A/CN.9/614, para. 34). That suggestion was made to address the specific case of arbitration in the context of bilateral investment treaties, where the parties to an investment arbitration treaty containing an arbitration clause differ from the parties to the arbitration. The Working Group might wish to consider whether the deletion of any reference to “parties” could lead to misinterpretation as to which parties are bound by the application of the Rules, particularly in arbitration cases which do not relate to any investment treaty.

“disputes in relation to that contract”

11. If the Working Group decides to retain option 1, it might wish to further discuss the question whether the types of disputes that parties could submit to

arbitration should be limited to “disputes in relation to that contract” (A/CN.9/614, paras. 32-34). It is recalled that the Working Group considered whether article 1, paragraph (1) should be widened to include words consistent with article 7 of the Model Law, which permitted arbitration of disputes “in respect of a defined legal relationship, whether contractual or not” (A/CN.9/614, paras. 32-33). Another option was to avoid limiting the scope of application of the Rules, and to omit any reference to a “contract” or “legal relationship” (A/CN.9/614, para. 33).

The writing requirement for the agreement to arbitrate and for modification of the Rules

12. The Working Group noted that the purpose of the requirement that the arbitration agreement be in writing was to set out the scope of application of the UNCITRAL Arbitration Rules and, unlike the function of the form requirement under the Model Law, might be separate from the question of the validity of the arbitration agreement (which is left to the applicable law) (A/CN.9/614, para. 28).

13. If the Working Group decides to omit the reference to the writing requirement from article 1 (A/CN.9/614, paras. 27-31), the drafting proposal would be to delete the words “in writing” appearing in brackets in the text.

Variants 1, 2 and 3

Applicable version of the UNCITRAL Arbitration Rules

14. Variants 1, 2 and 3 include proposals on the applicable version of the Rules.

15. Variant 1 corresponds to the current version of article 1, which does not include any indication as to the applicable version of the Rules in case of revision.

16. Variant 2 takes account of the preliminary discussions in the Working Group that:

- Some arbitral institutions include an express interpretative provision to the effect that the Rules in force on the date of the commencement of the arbitration (as opposed to the Rules in force on the date of the arbitration agreement) should apply unless the parties have agreed to the contrary (A/CN.9/614, para. 23);
- Some treaties expressly stipulate that, in the event of a revision of the UNCITRAL Arbitration Rules, the applicable version would be the one in force at the time that the arbitration commences (A/CN.9/614, para. 24).

17. Variant 3 addresses the observation made in the Working Group (A/CN.9/614, para. 23) that, in practice, some parties preferred to apply the most up-to-date Rules to their dispute, whereas others preferred the certainty of agreeing on the applicable version of the Rules in existence at the time the arbitration agreement was made.

18. The Working Group might wish to recall the observation made in the Working Group that any provision on the applicable version of the Rules should be consistent with the principle of party autonomy and, if the parties had agreed to apply the former version of the Rules, any transitional provision should not have any retroactive implications for that agreement (A/CN.9/614, para. 25).

19. It is recalled that the Working Group agreed to revisit that question once it had completed its review of the current text of the Rules (A/CN.9/614, para. 26).

References to previous UNCITRAL documents

“disputes in relation to that contract”

A/CN.9/614, paras. 32-34

A/CN.9/WG.II/WP.143, paras. 24-25

The writing requirement for the agreement to arbitrate and for modification of the Rules

A/CN.9/614, paras. 27-31

A/CN.9/WG.II/WP.143, paras. 12-23

Applicable version of the UNCITRAL Arbitration Rules

A/CN.9/614, paras. 22-26

A/CN.9/WG.II/WP.143, paras. 8-11

*MODEL ARBITRATION CLAUSE [**FOR CONTRACTS**]

Any dispute, controversy or claim arising out of or relating to this contract, or the breach, termination or invalidity thereof shall be settled by arbitration in accordance with the UNCITRAL Arbitration Rules [as at present in ~~force~~ effect].

Note — Parties may wish to consider adding:

- (a) The appointing authority shall be ... (name of institution or person);
- (b) The number of arbitrators shall be ... (one or three);
- (c) The place of arbitration shall be ... (town or country);
- (d) The language(s) to be used in the arbitral proceedings shall be ...
- (e) [The law governing the arbitration agreement shall be ...]

Remarks

Placement of the model arbitration clause

20. The Working Group might wish to consider the proposal to relocate the model arbitration clause if the proposal to modify article 1, paragraph (1), by deleting any reference to a contract, is adopted (A/CN.9/614, para. 38) (see above, paragraph 11).

Proposed modifications to the model arbitration clause

21. The words “as at present in force” are proposed to be replaced by the words “as at present in effect” to better reflect that the Rules have a contractual rather than legislative nature. These words are in brackets, as they should be considered for deletion if a provision referring to the applicable version of the Rules is adopted in article 1, paragraph (1) (see above, paragraphs 16 and 17).

Proposed addition to the note to the model arbitration clause

22. A proposal was made in the Working Group to add to the note to the model arbitration clause a reference to the law governing the arbitration agreement (A/CN.9/614, para. 37). Although that addition would have the benefit of raising awareness on the importance of defining the law applicable to the arbitration

agreement, it addresses only one aspect of the laws applicable in the context of arbitration. In order to further assist the parties on that question, the Working Group might wish to consider whether the model arbitration clause should include a provision on the law applicable to the substance of the dispute, and whether the impact of the place of arbitration on the law applicable to the arbitral proceedings should also be clarified.

23. In recognition of the benefit and value of conciliation as a means of alternative dispute resolution, the Working Group might wish to consider whether a reference to conciliation should be added, possibly in the form of an optional conciliation clause in order to encourage parties to first attempt to reach a settlement of their dispute with the assistance of a neutral third person.

Reference to previous UNCITRAL document

A/CN.9/614, paras. 36-38

Notice, calculation of periods of time

Article 2

1. For the purposes of these Rules, any notice, including a notification, communication or proposal, if not [personally][actually] received by the addressee, is deemed to have been received ~~if it is physically delivered to~~ by the addressee ~~or~~ if it is delivered at ~~his or her~~ its habitual residence, place of business or mailing address, or, if none of these can be found after making reasonable inquiry, then at the addressee's last-known residence or place of business. Notice shall be deemed to have been received on the day it is so delivered.

1 bis. Any notice may be delivered by electronic communication.

2. For the purposes of calculating a period of time under these Rules, such period shall begin to run on the day following the day when a notice, notification, communication or proposal is received. If the last day of such period is an official holiday or a non-business day at the residence or place of business of the addressee, the period is extended until the first business day, which follows. Official holidays or non-business days occurring during the running of the period of time are included in calculating the period.

Remarks

Paragraph (1)

Deemed delivery

24. The physical delivery of notices was listed in paragraph (1) as an option of delivery corresponding to the actual delivery of the notice. In order to clarify that meaning, it is proposed to replace the words “physical delivery” with the words “if not [personally][actually] received”. In addition, the proposed modification confirms the possibility of delivery of notices by electronic means as proposed in paragraph (1 bis).

*Paragraph (1 bis)**Delivery of the notice: "Electronic communication"*

25. The Working Group noted that a number of existing arbitration rules referred to delivery of notice by electronic means and it was suggested that article 2 should be amended to reflect contemporary practice (A/CN.9/614, para. 39).

*Paragraph (2)**Extend or shorten time periods*

26. The Working Group discussed whether paragraph (2) should be amended to provide that the arbitral tribunal might have an express power to extend or shorten the time periods stipulated under the UNCITRAL Arbitration Rules, as necessary for a fair and efficient process of resolving the parties' dispute (A/CN.9/614, paras. 41-46). A proposal was made to include in the Rules a general provision stating that: "In discharge of its duties under article 15, paragraph (1), the arbitral tribunal may at any time extend or abridge any period of time prescribed under or pursuant to the Rules."

27. During discussions on that matter, it was suggested that the power of the arbitral tribunal to modify time limits should be considered under article 15, which provided that the arbitral tribunal could conduct the arbitration in such manner as it considered appropriate. Whether or not that power was already provided under article 15 was subject to differing views (A/CN.9/614, paras. 43-44).

28. A question was raised whether the arbitrators should nevertheless be granted the power to modify time limits even where the parties had agreed on these matters (A/CN.9/614, para. 46).

29. It is recalled that the Working Group agreed that the issue could be assessed once the Working Group had examined all provisions that stipulated a time period, and had determined whether expressly establishing the power of the arbitral tribunal to extend or abridge stipulated time periods was appropriate in each context (A/CN.9/614, para. 45).

References to previous UNCITRAL documents*Paragraph (1) — Deemed delivery*

A/CN.9/614, para. 40

A/CN.9/WG.II/WP.143, paras. 27-29

Paragraph (1 bis) — Delivery of the notice: "Electronic communication"

A/CN.9/614, para. 39

A/CN.9/WG.II/WP.143, paras. 27-29

Paragraph (2)

A/CN.9/614, paras. 41-46

A/CN.9/WG.II/WP.143, paras. 30-31

Notice of arbitration and response to the notice of arbitration**Article 3**

1. The party initiating recourse to arbitration (hereinafter called the “claimant”) shall give to the other party [or parties] (hereinafter called the “respondent”) a notice of arbitration.
2. Arbitral proceedings shall be deemed to commence on the date on which the notice of arbitration is received by the respondent.
3. The notice of arbitration shall include the following:
 - (a) A demand that the dispute be referred to arbitration;
 - (b) The names and addresses of the parties;
 - (c) ~~A reference to the arbitration clause or the separate~~ Identification of the arbitration agreement that is invoked;
 - (d) ~~A reference to~~ Identification of any contract, ~~or other legal instrument,~~ out of or in relation to which the dispute arises;
 - (e) ~~The general nature~~ A brief description of the claim and an indication of the amount involved, if any;
 - (f) The relief or remedy sought;
 - (g) A proposal as to the number of arbitrators, ~~(i.e. one or three), language and place of arbitration,~~ if the parties have not previously agreed thereon.
4. The notice of arbitration may also include:
 - (a) The proposal for the appointment of an appointing authority referred to in article 4 bis;
 - (a) bis The proposal for the appointments of a sole arbitrator ~~and an appointing authority~~ referred to in article 6, paragraph 1;
 - (b) The notification of the appointment of an arbitrator referred to in article 7 or article 7 bis, paragraph 1;
 - [(c) The statement of claim referred to in article 18.]
5. Within thirty days of the receipt of the notice of arbitration, the respondent shall communicate to the claimant a response to the notice of arbitration, which shall include:
 - (a) Any comment on the demand that the dispute be referred to arbitration;
 - (b) The full name and address of any respondent;
 - (c) Any comment on the arbitration agreement, and on any contract or other legal instrument out of or in relation to which the dispute arises, that are invoked in the notice of arbitration;
 - (d) Any comment on the claim and the amount involved, if any;
 - (e) Any comment on the relief or remedy sought;

- (f) Any comment concerning the number of arbitrators, language and place of arbitration.
- 6. The response to the notice of arbitration may also include:
 - (a) Any comment on the proposal for the appointment of an appointing authority referred to in article 4 bis;
 - (b) Any comment on the proposal for the appointment of a sole arbitrator referred to in article 6, paragraph 1;
 - (c) Any comment on the notification of the appointment of an arbitrator referred to in article 7 or article 7 bis, paragraph 1;
 - (d) A brief description of counter-claims, if any, including where relevant, an indication of the amounts involved, and the relief or remedy sought.
- 7. Failure by the respondent to communicate a response to the notice of arbitration shall not prevent the arbitration from proceeding pursuant to these Rules.

Remarks

Paragraph (1)

30. The Working Group might wish to consider whether paragraph (1) should contain provisions to deal with multi-party arbitration.

Paragraphs (3) and (4)

Contents of notice of arbitration

- 31. A suggestion was made by the Working Group that article 3, paragraphs (3) and (4), which dealt with the contents of the notice of arbitration should be amended to include more detailed or additional information in the interests of improving efficiency of the arbitral procedure (A/CN.9/614, paras. 50-55).
- 32. The Working Group might wish to consider deleting the words “arbitration clause” in paragraph (3) (c) as an arbitration clause might be understood as falling under the more generic definition of arbitration agreement.
- 33. The words “or other legal instruments” in paragraph (3) (d) have been added to deal with the case where a dispute did not arise out of or in relation to a contract (A/CN.9/614, para. 51).
- 34. The amendment under paragraph (3) (e) is in accordance with the proposal made in the Working Group to replace the words “general nature” with the words “brief description” (A/CN.9/614, para. 53).
- 35. A reference to the “language and place of arbitration” has been added in paragraph 3 (g) in line with suggestions made in the Working Group (A/CN.9/614, para. 53). The reference to one or three arbitrators has been deleted, for the reasons explained below (see below, paragraph 43 on the number of arbitrators).
- 36. Paragraph (4) (a) has been split in two subparagraphs, to take account of the proposal to include a provision dealing with the appointing authority (see below, paragraphs 41 and 42 on article 4 bis). Under paragraph (4) (b), a reference has been

added to article 7 bis, which deals with the appointment of arbitrators in multi-party arbitration.

37. The Working Group might wish to consider whether the reference to the statement of claim should be maintained under paragraph (4) (c).

38. The Working Group might wish to further consider which items of the notice of arbitration should remain optional under paragraph (4), and whether the question of how to deal with an incomplete notice of arbitration should be addressed in the revised Rules or left to the discretion of the arbitral tribunal (A/CN.9/614, para. 54).

Paragraphs (5), (6) and (7)

Response to the notice of arbitration; contents and consequences of the failure to respond

39. The Working Group considered whether the respondent should be given an opportunity to state its position before the constitution of the arbitral tribunal, by responding to the notice of arbitration, and before the submission by the claimant of its statement of claim (A/CN.9/614, paras. 56-57). It was suggested that providing such an opportunity or, as proposed by some delegations, a procedural obligation, would have the added advantage of clarifying at an early stage of the proceeding the main issues raised by the dispute. It was said that inclusion of a right for the respondent to reply to the notice of arbitration would provide an appropriate balance between the claimant and the respondent (A/CN.9/614, para. 57). The Working Group might wish to consider the possible contents of the response to the notice of arbitration as defined under paragraphs (5) and (6), as well as the consequences for not responding, as referred to under paragraph (7).

References to previous UNCITRAL documents

Paragraphs (3) and (4): Contents of notice of arbitration

A/CN.9/614, paras. 50-55

A/CN.9/WG.II/WP.143, paras. 36-39

Paragraphs (5), (6) and (7): Response to the notice of arbitration; contents and consequences of the failure to respond

A/CN.9/614, paras. 56-57

A/CN.9/WG.II/WP.143, paras. 40-41

Representation and assistance

Article 4

The parties may be represented or assisted by persons of their choice. The names and addresses of such persons must be communicated in writing to ~~the other~~ all parties; such communication must specify whether the appointment is being made for purposes of representation or assistance [, and where a person is to act as a representative of a party, the communication shall provide information on the scope of authority of such person].

Representation of a party

40. The Working Group might wish to consider whether it would be useful to add language to article 4 aimed at ensuring that when a person is empowered to represent a party, the other party or parties are informed of the content of its representation powers and whether it should be clarified that the absence of such information would not deprive the communication of its validity.

Designating and appointing authorities**Article 4 bis**

1. The parties may agree on a person or institution, including the Secretary-General of the Permanent Court of Arbitration at The Hague, to act as appointing authority under these Rules.
2. In the event that the parties have not agreed on the identity of an appointing authority, or the appointing authority refuses or fails to act in accordance with these Rules, any party may request the Secretary-General of the Permanent Court of Arbitration at The Hague to designate an appointing authority.
3. The appointing authority may require from any party the information it deems necessary to exercise its functions. Copies of all requests or other communications between a party and the appointing authority or the Secretary-General of the Permanent Court of Arbitration at The Hague shall also be provided to all other parties.
4. When an appointing authority is requested to appoint an arbitrator pursuant to articles 6, 7 or 7 bis, the party which makes the request shall send to the appointing authority copies of the notice of arbitration and, if it exists, the response to the notice of arbitration.
5. The appointing authority shall have regard to such considerations as are likely to secure the appointment of an independent and impartial arbitrator and shall take into account as well the advisability of appointing an arbitrator of a nationality other than the nationalities of the parties. Where the names of one or more persons are proposed for appointment as arbitrators, their full names, addresses and nationalities shall be indicated, together with a description of their qualifications.
6. In all cases, the appointing authority may exercise its discretion in appointing an arbitrator.

Remarks*Specific provision on the designating and appointing authorities*

41. The Working Group might wish to consider including in the Rules a provision along the lines contained in article 4 bis, which is intended to deal with the designation and role of the appointing authority, which could be appointed by the parties at any time during the arbitration proceedings, and not only in cases currently provided for in the Rules. Such a provision might clarify for the parties the importance of the role of an appointing authority, particularly in the context of ad hoc arbitrations. That provision simplifies articles 6 and 7 on the appointment of arbitrators, as it includes provisions applicable to both. Article 8 would then

be deleted, as the provisions it contained would be placed in article 4 bis, paragraphs (3) and (5).

Extension of the role of the designating and appointing authorities

42. The Working Group might wish to consider whether the functions and roles of the designating authority and appointing authority should be modified.

Section II. Composition of the arbitral tribunal

Number of arbitrators

Article 5

1. *Option 1:* [If the parties have not previously agreed on the number of arbitrators (~~i.e. one or three~~), and if within [15][30] days after the receipt by the respondent of the notice of arbitration the parties have not agreed [*Variant 1:* that there shall be only one arbitrator, three arbitrators shall be appointed.] [*Variant 2:* on the number of arbitrators, ~~three~~ one arbitrators shall be appointed.]]

Option 2: [If the parties have not previously agreed on the number of arbitrators, the notice of arbitration shall contain a proposal on the number of arbitrators. If the Respondent has not agreed to that proposal by the time at which it is required to communicate its response, any party may request the appointing authority to decide whether one or three arbitrators shall be appointed.]

2. If the parties decide that the arbitral tribunal is to be composed of a number of arbitrators other than one or three, the arbitrators shall be appointed according to the methods agreed upon by the parties.

Remarks

Paragraph (1)

43. The Working Group might wish to recall that diverging views were expressed on whether the default rule on the number of arbitrators should be modified (A/CN.9/614, paras. 59-60). Under option 1, if the parties are unable to agree on the number of arbitrators, a default rule is provided, with two variants for consideration by the Working Group. Under option 2, if the parties are unable to agree, the appointing authority shall decide on the number of arbitrators.

Paragraph (2)

44. The purpose of the proposed paragraph (2) is to clarify that the Rules provide for methods to form either a one or a three member arbitral tribunal and if the parties wish to derogate from that rule (e.g., to have a two-member arbitral tribunal, which is allowed by the UNCITRAL Model Law), they should define their own method for the constitution of the arbitral tribunal.

References to previous UNCITRAL documents

A/CN.9/614, paras. 59-61

A/CN.9/WG.II/WP.143, paras. 42-44

Appointment of arbitrators (Articles 6 to 8)

Article 6

1. If a sole arbitrator is to be appointed, ~~either a party may propose to the other: (a) The names of one or more persons, one of whom would serve as the sole arbitrator; and~~

~~— (b) If no appointing authority has been agreed upon by the parties, the name or names of one or more institutions or persons, one of whom would serve as appointing authority.~~

2. If within 30 days after receipt by a party of a proposal made in accordance with paragraph (1) the parties have not reached agreement on the choice of a sole arbitrator, the sole arbitrator shall be appointed by the appointing authority agreed upon by the parties. If no appointing authority has been agreed upon by the parties, or if the appointing authority agreed upon refuses to act or fails to appoint the arbitrator within 60 days of the receipt of a party's request therefor, article 4 bis, paragraph (2) shall apply. ~~either party may request the Secretary General of the Permanent Court of Arbitration at The Hague to designate an appointing authority.~~

3. The appointing authority shall, at the request of a party, appoint the sole arbitrator as promptly as possible. In making the appointment the appointing authority shall use the following list procedure, unless the parties agree that the list-procedure should not be used or unless the appointing authority determines in its discretion that the use of the list procedure is not appropriate for the case:

(a) At the request ~~of one of the~~ of a parties the appointing authority shall communicate to ~~both the~~ parties an identical list containing at least three names;

(b) Within 15 days after the receipt of this list, each party may return the list to the appointing authority after having deleted the name or names to which it objects and numbered the remaining names on the list in the order of its preference;

(c) After the expiration of the above period of time the appointing authority shall appoint the sole arbitrator from among the names approved on the lists returned to it and in accordance with the order of preference indicated by the parties;

(d) If for any reason the appointment cannot be made according to this procedure, the appointing authority may exercise its discretion in appointing the sole arbitrator.

4. ~~In making the appointment, the appointing authority shall have regard to such considerations as are likely to secure the appointment of an independent and impartial arbitrator and shall take into account as well the advisability of appointing an arbitrator of a nationality other than the nationalities of the parties.~~

Remarks

45. The modifications to article 6 result from the inclusion of article 4 bis on the designating and appointing authorities. The provisions of paragraph (4) have been placed under article 4 bis, paragraph (5).

Article 7

1. If three arbitrators are to be appointed, each party shall appoint one arbitrator. The two arbitrators thus appointed shall choose the third arbitrator who will act as the presiding arbitrator of the arbitral tribunal.

2. If within 30 days after the receipt of a party's notification of the appointment of an arbitrator the other party has not notified the first party of the arbitrator ~~her or she~~ it has appointed:

(a) The first party may request the appointing authority previously designated by the parties to appoint the second arbitrator; or

(b) If no such authority has been previously designated by the parties, or if the appointing authority previously designated refuses to act or fails to appoint the arbitrator within 30 days after receipt of a party's request therefor, article 4 bis, paragraph (2) shall apply, and the ~~first party may request the Secretary General of the Permanent Court of Arbitration at The Hague to designate the appointing authority. The first party may then request the appointing authority so designated to appoint the second arbitrator. In either case, the appointing authority may exercise its discretion in appointing the arbitrator.~~

3. If within 30 days after the appointment of the second arbitrator the two arbitrators have not agreed on the choice of the presiding arbitrator, the presiding arbitrator shall be appointed by an appointing authority in the same way as a sole arbitrator would be appointed under article 6.

Remarks*Paragraph (2)*

46. The modifications to paragraph (2) are consequential amendments arising from the inclusion of article 4 bis on the designating and appointing authorities. The last sentence of paragraph (2) (b) has been placed under article 4 bis, paragraph (6).

Article 7 bis

1. Where there are multiple claimants or respondents, unless the parties have agreed to another method of appointment of arbitrators, the multiple claimants, jointly, and the multiple respondents, jointly, shall appoint an arbitrator. The two arbitrators thus appointed shall choose the third arbitrator who will act as the presiding arbitrator of the arbitral tribunal.

2. In the absence of appointment pursuant to paragraph 1, the appointing authority shall, at the request of any party, constitute the arbitral tribunal, and in doing so, may revoke any appointment already

made, and appoint each of the arbitrators and designate one of them as the presiding arbitrator; or confirm any appointment already made and make any further appointment.

Remarks

Appointment of arbitrators in multi-party arbitration

47. Article 7 bis has been inserted to deal with the appointment of arbitrators in multi-party cases, in accordance with the discussions of the Working Group (A/CN.9/614, paras. 62 and 63). The Working Group might wish to consider whether time limits should be defined under paragraph (2).

References to previous UNCITRAL documents

A/CN.9/614, paras. 62-63

A/CN.9/WG.II/WP.143, paras. 45-47

Article 8

~~1. When an appointing authority is requested to appoint an arbitrator pursuant to article 6 or article 7, the party which makes the request shall send to the appointing authority a copy of the notice of arbitration, a copy of the contract out of or in relation to which the dispute has arisen and a copy of the arbitration agreement if it is not contained in the contract. The appointing authority may require from either party such information, as it deems necessary to fulfil its function.~~

~~2. Where the names of one or more persons are proposed for appointment as arbitrators, their full names, addresses and nationalities shall be indicated, together with a description of their qualifications.~~

Remarks

48. The substance of article 8 has been placed under article 4 bis on the designating and appointing authorities.

Challenge of arbitrators (Articles 9 to 12)

Article 9

~~A prospective arbitrator shall disclose to those who approach him or her~~ When a person is approached in connexion with his or her possible appointment as an arbitrator, he or she shall disclose any circumstances likely to give rise to justifiable doubts as to his or her impartiality or independence. An arbitrator, ~~once appointed or chosen~~ from the time of his or her appointment and throughout the arbitral proceedings, shall without delay disclose any such circumstances to the parties unless they have already been informed by him or her of these circumstances.

Remarks*On-going nature of the duty to disclose*

49. The proposed amendments to article 9 reflect a suggestion made in the Working Group that the ongoing nature of the duty to disclose be clarified by using similar language to that used in article 12, paragraph (1), of the Model Law (A/CN.9/614, para. 64).

Model statement of independence

50. The Working Group might wish to consider whether guidance should be provided on the required content of the disclosure, in the form, for instance of a model statement of independence attached as a footnote to article 9 or in any accompanying material. Such model statement of independence could read as follows:

No circumstances to disclose: I am independent of each of the parties and intend to remain so. To the best of my knowledge, there are no circumstances, past or present, likely to give rise to justifiable doubts as to my impartiality. I hereby undertake promptly to notify the parties and the other members of the arbitral tribunal of any such circumstance that may subsequently come to my attention during this arbitration.

Circumstances to disclose: I am independent of each of the parties and intend to remain so. Attached is a statement of (a) my past and present professional, business and other relationships with the parties and (b) any other circumstance that might cause my reliability for independent and impartial judgment to be questioned by a party.[include statement] I hereby undertake promptly to notify the parties and the other members of the arbitral tribunal of any such further relationship or circumstance that may subsequently come to my attention during this arbitration.

References to previous UNCITRAL documents

A/CN.9/614, paras. 64-65

A/CN.9/WG.II/WP.143, para. 48

Article 10

1. Any arbitrator may be challenged if circumstances exist that give rise to justifiable doubts as to the arbitrator's impartiality or independence.
2. A party may challenge the arbitrator appointed by ~~him or her~~ it only for reasons of which ~~he or she~~ it becomes aware after the appointment has been made.

Remarks

51. No proposals for modification have been made in relation to article 10.

Article 11

1. A party who intends to challenge an arbitrator shall send notice of ~~his or her~~ its challenge within 15 days after the appointment of the challenged arbitrator has been notified to the challenging party or within 15 days after the circumstances mentioned in articles 9 and 10 became known to that party.
2. The challenge shall be notified to ~~the~~ all other parties, to the arbitrator who is challenged and to the other members of the arbitral tribunal. The notification shall be in writing and shall state the reasons for the challenge.
3. When an arbitrator has been challenged by ~~one~~ a party, ~~the~~ all other parties may agree to the challenge. The arbitrator may also, after the challenge, withdraw from his or her office. In neither case does this imply acceptance of the validity of the grounds for the challenge. In both cases the procedure provided in article 6 or 7 shall be used in full for the appointment of the substitute arbitrator, even if during the process of appointing the challenged arbitrator a party had failed to exercise ~~his or her~~ its right to appoint or to participate in the appointment.

Remarks

52. No proposals for modification have been made in relation to article 11.

Article 12

1. If, within [15] [30] days from the date of the notice of challenge, ~~the any~~ other party does not agree to the challenge and the challenged arbitrator does not withdraw, the party making the challenge may seek, within 60 days from date of the notice of challenge, a decision on the challenge, which will be made:
 - (a) When the initial appointment was made by an appointing authority, by that authority;
 - (b) When the initial appointment was not made by an appointing authority, but an appointing authority has been previously designated, by that authority;
 - (c) In all other cases, by the appointing authority to be designated in accordance with the procedure for designating an appointing authority as provided for in article ~~6~~ 4 bis.
2. If the appointing authority sustains the challenge, a substitute arbitrator shall be appointed or chosen pursuant to the procedure applicable to the appointment or choice of an arbitrator as provided in articles 6 to 9 except that, when this procedure would call for the designation of an appointing authority, or if the appointing authority considers that the circumstances of the arbitration so warrant, the appointment of the arbitrator shall be made by the appointing authority ~~which decided on the challenge~~.

Remarks*Paragraph (1)**Time limits for challenge*

53. The Working Group might wish to further consider revising article 12 so as to introduce time limits by which the party making a challenge should seek a decision by the appointing authority (A/CN.9/614, para. 66).

Paragraph (2)

54. The modification proposed indicates that the appointing authority may directly appoint an arbitrator if the circumstances of the case are such that a party should be deprived of its right to appoint a replacement arbitrator. This could apply in the situation, for example, where a party repetitively used the challenge procedure to delay the arbitral process.

References to previous UNCITRAL documents

A/CN.9/614, para. 66

A/CN.9/WG.II/WP.143, para. 49

Replacement of an arbitrator**Article 13**

1. In the event of the death or resignation of an arbitrator during the course of the arbitral proceedings, a substitute arbitrator shall be appointed or chosen pursuant to the procedure provided for in articles 6 to 9 that was applicable to the appointment or choice of the arbitrator being replaced.

2. In the event that a party considers that an arbitrator has resigned for invalid reasons or is failing to perform his or her functions, it may apply to the appointing authority to request either the replacement of that arbitrator or the authorization for the other arbitrators to proceed with the arbitration and make any decision or award. If the appointing authority considers that the circumstances of the arbitration warrant a substitute arbitrator to be appointed, it shall decide whether to apply the procedure for the appointment of an arbitrator provided for in articles 6 to 9 or to appoint the substitute arbitrator. ~~an arbitrator refuses or fails to act, or in the event of the de jure or de facto impossibility of his or her performing his or her functions, the procedure in respect of the challenge and replacement of an arbitrator as provided in the preceding articles shall apply.~~

Remarks*Paragraph (2)**Unapproved resignation or failure to perform*

55. In accordance with discussions of the Working Group, paragraph (2) provides two different ways of dealing with an unapproved resignation of an arbitrator or failure by an arbitrator to perform his or her functions: the appointing authority may decide either to appoint directly a substitute arbitrator, depriving the party having

initially appointed such arbitrator to proceed with the appointment of its replacement, or to allow the proceedings to continue without a substitute arbitrator (A/CN.9/614, para. 70). The appointing authority shall determine, by reference to the relevant facts and circumstances, whether the resignation or non-performance was acceptable or not (A/CN.9/614, para. 69). The Working Group might wish to consider whether there are circumstances in which the arbitrators themselves, rather than just a party, should be given the power either to decide to proceed as a truncated tribunal or to seek approval for so proceeding.

References to previous UNCITRAL documents

Resignation of an arbitrator

A/CN.9/614, paras. 67-69

A/CN.9/WG.II/WP.143, paras. 51-53.

Consequences of a bad faith resignation

A/CN.9/614, paras. 70-72

A/CN.9/WG.II/WP.143, para. 54

Truncated tribunals

A/CN.9/614, paras. 73-74

A/CN.9/WG.II/WP.143, paras. 55-57

Repetition of hearings in the event of the replacement of an arbitrator

Article 14

If under articles 11 to 13 an arbitrator is replaced, the proceedings shall resume at the stage where the arbitrator who was replaced ceased to perform his or her functions, unless the arbitral tribunal decides otherwise.

Remarks

56. Article 14 has been revised to take account of the suggestion made in the Working Group that article 14 should be drafted along the lines of article 14 of the Swiss Rules of International Arbitration, which provided that in case of replacement of an arbitrator, the proceedings should resume at the stage where the arbitrator who was replaced ceased his or her functions, unless the arbitral tribunal decided otherwise (A/CN.9/614, para. 75).

References to previous UNCITRAL documents

A/CN.9/614, para. 75

A/CN.9/WG.II/WP.143, paras. 58-61

A/CN.9/WG.II/WP.145/Add.1 [Original: English]**Note by the Secretariat on settlement of commercial disputes: Revision of the
UNCITRAL Arbitration Rules, submitted to the Working Group on
Arbitration at its forty-sixth session****ADDENDUM****CONTENTS**

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Introduction

1. At its thirty-ninth session (New York, 19 June-7 July 2006), the Commission agreed that, in respect of future work of the Working Group, priority be given to a revision of the UNCITRAL Arbitration Rules (1976) (“the UNCITRAL Arbitration Rules” or “the Rules”).¹ At its forty-fifth session (Vienna, 11-15 September 2006), the Working Group undertook to identify areas where a revision of the UNCITRAL Arbitration Rules might be useful.

2. This note contains an annotated draft of revised UNCITRAL Arbitration Rules based on the deliberation of the Working Group at its forty-fifth session and continues from article 15 of the Rules. Articles 1 to 14 are dealt with under A/CN.9/WG.II/WP.145. All references to discussions and considerations by the Working Group in the note are to discussions and considerations made at the forty-fifth session of the Working Group.

¹ *Official Records of the General Assembly, Sixty-first Session, Supplement No. 17 (A/61/17)*, paras. 182-187.

Notes on a draft of revised UNCITRAL Arbitration Rules

Section III. Arbitral proceedings

General provisions

Article 15

1. Subject to these Rules, the arbitral tribunal may conduct the arbitration in such manner as it considers appropriate, provided that the parties are treated with equality and that at any appropriate stage of the proceedings each party is given an full opportunity of presenting its case. The arbitral tribunal, in exercising its discretion, shall conduct the proceedings with a view to avoid unnecessary delay and expense and to provide a fair and efficient process for resolving the parties' dispute.

2. If, at any appropriate stage of the proceedings, either any party so requests at any appropriate stage of the proceedings, the arbitral tribunal shall hold hearings for the presentation of evidence by witnesses, including expert witnesses, or for oral argument. In the absence of such a request, the arbitral tribunal shall decide whether to hold such hearings or whether the proceedings shall be conducted on the basis of documents and other materials.

3. All documents or information supplied to the arbitral tribunal by one party shall at the same time be communicated by that party to the all other parties.

4. The arbitral tribunal may, on the application of any party:

(a) assume jurisdiction over any claim involving the same parties and arising out of the same legal relationship, provided that such claims are subject to arbitration under these Rules and that the arbitration proceedings in relation to those claims have not yet commenced;

(b) allow one or more third persons to be joined in the arbitration as a party and, provided such a third person and the applicant party have consented, make an award in respect of all parties involved in the arbitration.

Remarks

Paragraph (1)

Avoidance of unnecessary delays

3. The proposed added language to paragraph (1) deals with the question of delays in arbitral proceedings. The Working Group heard the view that inclusion of such a principle was unnecessary, but that it might nevertheless be useful to provide leverage for arbitrators to take certain steps both vis-à-vis the other arbitrators and the parties (A/CN.9/614, para. 76).

Paragraphs (1) and (2)

“at the appropriate stage” — “an opportunity”

4. The replacement of the words “at any stage of proceedings” by “at an appropriate stage”, and of the phrase “a full opportunity” with “an opportunity” reflects the discussions of the Working Group (A/CN.9/614, para. 77).

Paragraph (4)

Consolidation of cases before arbitral tribunals — joinder

5. Paragraph (4) seeks to address the question of consolidation of cases and joinder. The Working Group might wish to further discuss the workability of such provisions given that the Rules also often apply in non-administered cases (A/CN.9/614, paras. 79-83).

6. The Working Group might wish to note that paragraph (4) (b) on joinder is inspired by article 22.1 (h) of the LCIA Arbitration Rules.

Confidentiality of proceedings

7. The Working Group might wish to further consider whether it would be appropriate to include a general provision regarding confidentiality of proceedings, or of the materials (including pleadings) before the arbitral tribunal.

8. The Working Group noted that the matter of confidentiality was quite complex, that there were diverse views expressed on the importance of confidentiality and that practices and the law were still evolving. It was said that regulating that issue in too much detail could constitute a major departure from the UNCITRAL Arbitration Rules. It was observed that the scope of confidentiality needed could depend on the subject matter of the dispute and the applicable regulatory regimes. The opinion that a general confidentiality provision should not be included was expressed by many delegations. It was also suggested that the matter should be left to be addressed on a case-by-case basis by the arbitrators and the parties (A/CN.9/614, paras.84-86).

References to previous UNCITRAL documents

Paragraph (1) — Avoidance of unnecessary delays

A/CN.9/614, para. 76

A/CN.9/WG.II/WP.143, para. 62

Paragraphs (1) and (2) — “appropriate stage”

A/CN.9/614, para. 77

Paragraph (4) — Consolidation of cases before arbitral tribunals — joinder

A/CN.9/614, paras. 79-83

A/CN.9/WG.II/WP.143, paras. 66-71

Confidentiality of proceedings

A/CN.9/614, paras. 84-86

A/CN.9/WG.II/WP.143, paras. 72-74

Place of arbitration

Article 16

1. Unless the parties have agreed upon the [*option 1*: place] [*option 2*: seat] where the arbitration is to be held, such [*option 1*: place] [*option 2*: seat of arbitration] shall be determined by the arbitral tribunal, having regard to the circumstances of the arbitration.
2. The arbitral tribunal may determine the [*option 1*: location] [*option 2*: place] of the arbitration within the country agreed upon by the parties. It may hear witnesses and hold meetings for consultation among its members at any [place] [location] it deems appropriate, having regard to the circumstances of the arbitration.
3. The arbitral tribunal may meet at any [*option 1*: place] [*option 2*: location] it deems appropriate for the inspection of goods, other property or documents. The parties shall be given sufficient notice to enable them to be present at such inspection.
4. The award shall be deemed to have been made at the [*option 1*: place] [*option 2*: seat] of arbitration.

Remarks

“Place of arbitration” — “seat of arbitration” — “location of arbitration”

9. It is recalled that the Working Group considered whether to clarify the term “place of arbitration” in article 16. The Working Group also considered, but did not reach a conclusion, whether the Rules should remain consistent with the Model Law (which currently uses the expression “place of arbitration”) or whether a differentiated terminology should be used, such as “seat of arbitration” when dealing with the legal place of arbitration, or “location”, when dealing with the place where meetings are actually held. Options are proposed for consideration by the Working Group (A/CN.9/614, paras. 87-89).

Paragraph (4)

“shall be deemed”

10. Paragraph (4) has been amended to take account of a proposal made to provide that an award should be deemed to have been made at the place of arbitration to avoid the uncertainty as to the jurisdiction of courts regarding the award if it was signed in a place other than the seat of arbitration. This wording is consistent with the wording used in article 31, paragraph (3), of the Model Law (A/CN.9/614, para. 90). Article 32, paragraph (4), of the Rules has been changed to take account of that proposed modification (see below, paragraph 34).

References to previous UNCITRAL documents

“Place of arbitration” — “seat of arbitration” — “location”

A/CN.9/614, paras. 87-89

A/CN.9/WG.II/WP.143, paras. 75-76

Paragraph (4) — “shall be deemed”

A/CN.9/614, para. 90

Language

Article 17

1. Subject to an agreement by the parties, the arbitral tribunal shall, promptly after its appointment, determine the language or languages to be used in the proceedings. This determination shall apply to the statement of claim, the statement of defence, and any further written statements and, if oral hearings take place, to the language or languages to be used in such hearings.

2. The arbitral tribunal may order that any documents annexed to the statement of claim or statement of defence, and any supplementary documents or exhibits submitted in the course of the proceedings, delivered in their original language, shall be accompanied by a translation into the language or languages agreed upon by the parties or determined by the arbitral tribunal.

Remarks

11. No proposals for modification have been made in relation to article 17.

References to previous UNCITRAL documents

A/CN.9/614, para. 91

A/CN.9/WG.II/WP.143/Add.1, para. 3

Statement of claim

Article 18

1. Unless the statement of claim was contained in the notice of arbitration, within a period of time to be determined by the arbitral tribunal, the claimant shall communicate ~~his or her~~ its statement of claim in writing to the respondent and to each of the arbitrators. A copy of the contract, and of the arbitration agreement if not contained in the contract, shall be annexed thereto.

2. The statement of claim shall include the following particulars:

- (a) The names and addresses of the parties;
- (b) A statement of the facts supporting the claim;
- (c) The points at issue;
- (d) The relief or remedy sought.

The claimant may annex to its statement of claim all documents ~~he or she~~ it deems relevant or may add a reference to the documents or other evidence ~~he or she~~ it will submit.

Remarks

Paragraph (2)

12. The Working Group might wish to consider whether paragraph (2) (b) should be reformulated to read “a statement of the facts and legal principles supporting the claim” in order to encourage the parties to substantiate their claims from a legal point of view. As well, the Working Group might wish to consider whether that provision should address the question of statement of claim in multi-party arbitration.

13. The Working Group might wish to consider whether the last paragraph of article 18 (2) should be reworded so that the claimant would have an obligation, to the extent feasible, to submit together with its statement of claim documents and evidence which are relevant to the claim. That paragraph could read: “The statement of claim shall, as far as possible, be accompanied by all documents and other evidentiary materials relied upon by the claimant or by references to them.”

References to previous UNCITRAL documents

A/CN.9/614, para. 92

A/CN.9/WG.II/WP.143/Add.1, paras. 4-7

Statement of defence

Article 19

1. Within a period of time to be determined by the arbitral tribunal, the respondent shall communicate its statement of defence in writing to the claimant and to each of the arbitrators.

2. The statement of defence shall reply to the particulars (b), (c) and (d) of the statement of claim (article 18, para. 2). The respondent may annex to its statement the documents on which it relies for its defence or may add a reference to the documents or other evidence it will submit.

3. In its statement of defence, or at a later stage in the arbitral proceedings if the arbitral tribunal decides that the delay was justified under the circumstances, the respondent may make a counter-claim or rely on a claim for the purpose of a set-off arising out of the same contract legal relationship, whether contractual or not, or rely on a claim arising out of the same contract for the purpose of a set-off.

4. The provisions of article 18, paragraph 2, shall apply to a counter claim and a claim relied on for the purpose of a set-off.

Paragraph (1)

14. The Working Group might wish to consider whether that provision should address the question of statement of defence in multi-party arbitration.

Paragraph (2)

15. If the modification proposed in relation to article 18, paragraph (2), is adopted (see above, paragraph 13), article 19, paragraph (2), should then be modified accordingly, and could read: “The statement of defence shall, as far as possible, be

accompanied by all documents and other evidentiary material relied upon by the respondent or by references to them.”

Paragraph 3

Raising claims for the purpose of set-off

16. Article 19, paragraph (3), of the UNCITRAL Arbitration Rules provides that the respondent might make a counter-claim or rely on a claim for the purpose of a set-off if the claim arose “out of the same contract”. Views were expressed in the Working Group that the arbitral tribunal’s competence to consider counter-claims or set-off should, under certain conditions, extend beyond the contract from which the principal claim arose and apply in a wider range of circumstances (A/CN.9/614, para. 93). To achieve that extension, it was proposed to replace the words “arising out of the same contract” with the words “arising out of the same legal relationship, whether contractual or not” (A/CN.9/614, para. 94).

References to previous UNCITRAL documents

A/CN.9/614, paras. 93-96

A/CN.9/WG.II/WP.143/Add.1, paras. 8-10.

Amendments to the claim or defence

Article 20

During the course of the arbitral proceedings ~~either~~ a party may amend or supplement ~~his or her~~ its claim or defence unless the arbitral tribunal considers it inappropriate to allow such amendment having regard to the delay in making it or prejudice to ~~the~~ all other parties or any other circumstances. However, a claim may not be amended in such a manner that the amended claim falls outside the scope of the arbitration clause or separate arbitration agreement.

Remarks

17. No proposals for modification have been made in relation to article 20.

Pleas as to the jurisdiction of the arbitral tribunal

Article 21

~~1. The arbitral tribunal shall have the power to rule on objections that it has no jurisdiction, including any objections with respect to the existence or validity of the arbitration clause or of the separate arbitration agreement.~~

~~2. The arbitral tribunal shall have the power to determine the existence or the validity of the contract of which an arbitration clause forms a part. For the purposes of article 21, an arbitration clause which forms part of a contract and which provides for arbitration under these Rules shall be treated as an agreement independent of the other terms of the contract. A decision by the arbitral tribunal that the contract is null and void shall not entail ipso jure the invalidity of the arbitration clause.~~

1. The arbitral tribunal may rule on its own jurisdiction, including any objections with respect to the existence or validity of the arbitration agreement. For that purpose, an arbitration clause which forms part of a contract shall be treated as an agreement independent of the other terms of the contract. A decision by the arbitral tribunal that the contract is null and void shall not entail ipso jure the invalidity of the arbitration clause.
2. A plea that the arbitral tribunal does not have jurisdiction shall be raised not later than in the statement of defence or, with respect to a counter-claim, in the reply to the counter-claim. A party is not precluded from raising such a plea by the fact that it has appointed, or participated in the appointment of, an arbitrator. A plea that the arbitral tribunal is exceeding the scope of its authority shall be raised as soon as the matter alleged to be beyond the scope of its authority is raised during the arbitral proceedings. The arbitral tribunal may, in either case, admit a later plea if it considers the delay justified.
3. ~~In general, the arbitral tribunal should rule on a plea concerning its jurisdiction as a preliminary question. However, the arbitral tribunal may proceed with the arbitration and rule on such a plea in their final award.~~ The arbitral tribunal may rule on a plea referred to in paragraph (2) of this article either as a preliminary question or in an award on the merits. The arbitral tribunal may continue the arbitral proceedings and make an award, notwithstanding any pending challenge to its jurisdiction before a court.

Remarks

Paragraph (1)

18. Paragraph (1) reflects the view expressed in the Working Group that the existing version of article 21, paragraphs (1) and (2), should be redrafted along the lines of article 16, paragraph (1), of the Model Law in order to make it clear that the arbitral tribunal had the power to raise and decide upon issues regarding the existence and scope of its own jurisdiction (A/CN.9/614, para. 97).

Paragraph (2)

19. A view was expressed in the Working Group that the existing version of article 21, paragraph (3), of the Rules should contain a provision similar to article 16, paragraph (2), of the Model Law, which provided that a party was not precluded from raising a plea as to jurisdiction by the fact that it had appointed, or participated in the appointment of, an arbitrator, and that the arbitral tribunal might, in either case, admit a later plea if it considered the delay justified (A/CN.9/614, para. 98).

Paragraph (3)

20. Paragraph (3), which replaces the existing version of article 21, paragraph (4), of the Rules contains a provision consistent with article 16, paragraph (3), of the Model Law, in accordance with the Working Group discussions (A/CN.9/614, paras. 99-102).

References to previous UNCITRAL documents

A/CN.9/614, paras. 97-102

A/CN.9/WG.II/WP.143/Add.1, paras. 11-14.

Further written statements**Article 22**

The arbitral tribunal shall decide which further written statements, in addition to the statement of claim and the statement of defence, shall be required from the parties or may be presented by them and shall fix the periods of time for communicating such statements.

Remarks

21. No proposals for modification have been made in relation to article 22.

Periods of time**Article 23**

The periods of time fixed by the arbitral tribunal for the communication of written statements (including the statement of claim and statement of defence) should not exceed 45 days. However, the arbitral tribunal may extend the time limits if it concludes that an extension is justified.

Remarks

22. No proposals for modification have been made in relation to article 23.

Evidence and hearings (Articles 24 and 25)**Article 24**

1. Each party shall have the burden of proving the facts relied on to support ~~his or her~~ its claim or defence.

[2. The arbitral tribunal may, if it considers it appropriate, require a party to deliver to the tribunal and to ~~the~~ all other parties, within such a period of time as the arbitral tribunal shall decide, a summary of the documents and other evidence which that party intends to present in support of the facts in issue set out in ~~his or her~~ its statement of claim or statement of defence.]

3. At any time during the arbitral proceedings the arbitral tribunal may require the parties to produce documents, exhibits or other evidence within such a period of time, as the tribunal shall determine.

Remarks*Paragraph (2)*

23. The Working Group might wish to consider whether paragraph (2) should be deleted, as it might not be common practice for an arbitral tribunal to require parties to present a summary of documents and as it may be desirable to promote a system

according to which the parties would attach to their claims the evidentiary materials they are relying on.

References to previous UNCITRAL documents

A/CN.9/614, para. 103

A/CN.9/WG.II/WP.143/Add.1, paras. 15

Article 25

1. In the event of an oral hearing, the arbitral tribunal shall give the parties adequate advance notice of the date, time and place thereof.

2. If witnesses are to be heard, at least 15 days before the hearing each party shall communicate to the arbitral tribunal and to ~~the~~ all other parties the names and addresses of the witnesses ~~he or she~~ it intends to present, the subject upon and the languages in which such witnesses will give their testimony.

2 bis [Witnesses may be heard under conditions set by the arbitral tribunal. Any individual testifying to the arbitral tribunal on any issue of fact or expertise shall be treated as a witness under these Rules notwithstanding that the individual is a party to the arbitration or was or is an officer, employee or shareholder of any party.]

3. The arbitral tribunal shall make arrangements for the translation of oral statements made at a hearing and for a record of the hearing if either is deemed necessary by the tribunal under the circumstances of the case, or if the parties have agreed thereto and have communicated such agreement to the tribunal at least 15 days before the hearing.

4. Hearings shall be held *in camera* unless the parties agree otherwise. The arbitral tribunal may require the retirement of any witness or witnesses during the testimony of other witnesses. The arbitral tribunal is free to determine the manner in which witnesses are examined.

5. Evidence of witnesses may also be presented in the form of written statements signed by them.

6. The arbitral tribunal shall determine the admissibility, relevance, materiality and weight of the evidence offered.

Remarks

Paragraph (2)

24. The Working Group might wish to note that the reference to “witnesses” might be problematic in some legal systems, where the parties themselves, and their senior officers or employees cannot be characterized as witnesses. Paragraph 2bis proposes a definition of “witness” and sets out in more detail the power of the arbitral tribunal.

Interim measures

Article 26

~~1. At the request of either party, the arbitral tribunal may take any interim measures it deems necessary in respect of the subject matter of the dispute, including measures for the conservation of the goods forming the subject matter in dispute, such as ordering their deposit with a third person or the sale of perishable goods.~~

~~2. Such interim measures may be established in the form of an interim award. The arbitral tribunal shall be entitled to require security for the costs of such measures.~~

~~3. A request for interim measures addressed by any party to a judicial authority shall not be deemed incompatible with the agreement to arbitrate, or as a waiver of that agreement.~~

1. The arbitral tribunal may, at the request of a party, grant interim measures.

2. An interim measure is any temporary measure by which, at any time prior to the issuance of the award by which the dispute is finally decided, the arbitral tribunal orders a party to:

(a) Maintain or restore the status quo pending determination of the dispute;

(b) Take action that would prevent, or refrain from taking action that is likely to cause, current or imminent harm or prejudice to the arbitral process itself;

(c) Provide a means of preserving assets out of which a subsequent award may be satisfied; or

(d) Preserve evidence that may be relevant and material to the resolution of the dispute.

3. The party requesting an interim measure under paragraph 2 (a), (b) and (c) shall satisfy the arbitral tribunal that:

(a) Harm not adequately reparable by an award of damages is likely to result if the measure is not ordered, and such harm substantially outweighs the harm that is likely to result to the party against whom the measure is directed if the measure is granted; and

(b) There is a reasonable possibility that the requesting party will succeed on the merits of the claim. The determination on this possibility shall not affect the discretion of the arbitral tribunal in making any subsequent determination.

4. With regard to a request for an interim measure under paragraph 2 (d), the requirements in paragraph 3 (a) and (b) shall apply only to the extent the arbitral tribunal considers appropriate.

5. The arbitral tribunal may modify, suspend or terminate an interim measure it has granted, upon application of any party or, in exceptional circumstances and upon prior notice to the parties, on the arbitral tribunal's own initiative.

6. The arbitral tribunal may require the party requesting an interim measure to provide appropriate security in connection with the measure.
7. The arbitral tribunal may require any party promptly to disclose any material change in the circumstances on the basis of which the measure was requested or granted.
8. The party requesting an interim measure shall be liable for any costs and damages caused by the measure to any party if the arbitral tribunal later determines that, in the circumstances, the measure should not have been granted. The arbitral tribunal may award such costs and damages at any point during the proceedings.

Remarks

25. Article 26 has been amended to take account of the suggestion made in the Working Group that the revised provision on interim measures might clarify the circumstances, conditions and procedure for the granting of interim measures, consistent with Chapter IV A of the Model Law, or be drafted in such a way that they would give effect to the party autonomy provided by Chapter IV A (A/CN.9/614, para. 105).

26. The Working Group might wish to consider whether provisions on preliminary orders should be included in article 26.

References to previous UNCITRAL documents

A/CN.9/614, paras. 104-105

A/CN.9/WG.II/WP.143/Add.1, para. 16

Experts

Article 27

1. The arbitral tribunal may appoint one or more experts to report to it, in writing, on specific issues to be determined by the tribunal. A copy of the experts' terms of reference, established by the arbitral tribunal, shall be communicated to the parties.
2. The parties shall give the expert any relevant information or produce for his or her inspection any relevant documents or goods that he or she may require of them. Any dispute between a party and such expert as to the relevance of the required information or production shall be referred to the arbitral tribunal for decision.
3. Upon receipt of the experts report, the arbitral tribunal shall communicate a copy of the report to the parties who shall be given the opportunity to express, in writing, their opinion on the report. A party shall be entitled to examine any document on which the expert has relied in his or her report.
4. At the request of ~~either~~ any party the expert, after delivery of the report, may be heard at a hearing where the parties shall have the opportunity to be present and to interrogate the expert. At this hearing ~~either~~ any party may present expert witnesses in order to testify on the

points at issue. The provisions of article 25 shall be applicable to such proceedings.

Remarks

27. No proposals for modification have been made in relation to article 27.

References to previous UNCITRAL documents

A/CN.9/614, paras. 106-107

A/CN.9/WG.II/WP.143/Add.1, paras. 17-20

Default

Article 28

1. If, within the period of time fixed by the arbitral tribunal, the claimant has failed to communicate its statement of claim without showing sufficient cause for such failure, the arbitral tribunal shall issue an order for the termination of the arbitral proceedings, unless the respondent has submitted a counter-claim. If, within the period of time fixed by the arbitral tribunal, the respondent has failed to communicate its statement of defence without showing sufficient cause for such failure, the arbitral tribunal shall order that the proceedings continue, without treating such failure in itself as an admission of the claimant's allegations.

2. If ~~one of the~~ a party, duly notified under these Rules, fails to appear at a hearing, without showing sufficient cause for such failure, the arbitral tribunal may proceed with the arbitration.

3. If ~~one of the~~ a party, duly invited by the arbitral tribunal to produce documentary evidence, fails to do so within the established period of time, without showing sufficient cause for such failure, the arbitral tribunal may make the award on the evidence before it.

Remarks

28. The Working Group might wish to consider the proposed modifications to article 28, which are made for the sake of clarity. The addition at the end of paragraph (1) reflects the provisions in article 25 of the Model Law.

Closure of hearings

Article 29

1. The arbitral tribunal may inquire of the parties if they have any further proof to offer or witnesses to be heard or submissions to make and, if there are none, it may declare the hearings closed.

2. The arbitral tribunal may, if it considers it necessary owing to exceptional circumstances, decide, on its own motion or upon application of a party, to reopen the hearings at any time before the award is made.

Remarks

29. No proposals for modification have been made in relation to article 29.

Waiver of rules**Article 30**

A party, who knows that any provision of, or requirement under, these Rules has not been complied with and yet proceeds with the arbitration without promptly stating ~~his or her~~ its objection to such non-compliance, shall be deemed to have waived ~~his or her~~ its right to object.

Section IV. The award**Decisions****Article 31**

1. When there are three arbitrators, any award or other decision of the arbitral tribunal shall be made by a majority of the arbitrators. [When there is no majority, any award or other decision shall be made by the presiding arbitrator alone.]
2. In the case of questions of procedure, when there is no majority or when the arbitral tribunal so authorizes, the presiding arbitrator may decide ~~on his or her own~~ alone, subject to revision, if any, by the arbitral tribunal.

Remarks*Paragraph (1)*

30. It is recalled that, given the differing views expressed, the Working Group requested the Secretariat to prepare various options for consideration by the Working Group (A/CN.9/614, para. 112). One option was to leave article 31 unchanged (A/CN.9/614, para. 111); another option was to revise that paragraph in order to avoid a deadlock situation where no majority decision could be made and to provide that if an arbitral tribunal composed of three arbitrators could not reach a majority, then the award would be decided by the presiding arbitrator as if he or she were a sole arbitrator (A/CN.9/614, para. 108).

31. If the added words are retained, consequential amendments to article 32, paragraph (4), relating to the signing of the award might also need to be considered.

References to previous UNCITRAL documents

A/CN.9/614, paras. 108-112

A/CN.9/WG.II/WP.143/Add.1, paras. 21-24

Form and effect of the award

Article 32

1. [In addition to making a final award, the arbitral tribunal shall be entitled to make interim or interlocutory, ~~or partial~~ awards.]
2. ~~The~~ An award shall be made in writing and shall be final and binding on the parties. The parties undertake to carry out the award without delay and shall be deemed to have waived their right to any form of appeal, review or recourse to any court or other competent authority, insofar as such waiver can be validly made.
3. The arbitral tribunal shall state the reasons upon which the award is based, unless the parties have agreed that no reasons are to be given.
4. An award shall be signed by the arbitrators and it shall contain the date on which the award was made and indicate the place of arbitration. Where there are three arbitrators and one of them fails to sign, the award shall state the reason for the absence of the signature.
5. [*Option 1:* The award may be made public only with the consent of ~~both~~ the parties.] [*Option 2:* The award may be made public with the consent of the parties or where and to the extent disclosure is required of a party by legal duty to protect or pursue a legal right or in relation to legal proceedings before a court or other competent authority.]
6. Copies of the award signed by the arbitrators shall be communicated to the parties by the arbitral tribunal.
7. If the arbitration law of the country where the award is made requires that the award be filed or registered by the arbitral tribunal, the tribunal shall comply with this requirement at the timely request of any party, within the period of time required by law.

Remarks

Paragraph (1)

Form of the award

32. The Working Group might wish to consider whether the types of awards should be left to the practice, and whether paragraph (1) should be deleted.

Paragraph (2)

Waiver of recourse to courts

33. In accordance with a proposal made in the Working Group, the language inserted in paragraph (2) seeks to make it impossible for parties to use recourse to courts that could be freely waived by the parties (for example, in some jurisdictions, an appeal on a point of law), but not to exclude challenges to the award (for example, on matters such as lack of jurisdiction, violation of due process or any other ground for setting aside the award as set out under article 34 of the Model Law), inasmuch as the parties could not exclude them by contract (A/CN.9/614, para. 114).

Paragraph (4)

34. The modification is proposed to be made for the sake of consistency with the modification under article 16, paragraph (4), which deals with the place where the award is deemed to be made (see above, paragraph 10).

Paragraph (5)

35. As agreed by the Working Group, paragraph (5) offers options on the question of publication of awards. Option 1 corresponds to the existing text of the Rules, whereas option 2 covers the situation where a party is under a legal obligation to disclose.

Paragraph (7)

36. Paragraph (7) has been amended so as to avoid an onerous burden being placed on an arbitral tribunal which might not be familiar with the registration requirements at the place of arbitration.

References to previous UNCITRAL documents

A/CN.9/614, paras. 113-121

A/CN.9/WG.II/WP.143/Add.1, paras. 25-29

Applicable law, amiable compositeur**Article 33**

1. The arbitral tribunal shall apply the [*option 1: law*][*option 2: rules of law*] designated by the parties as applicable to the substance of the dispute. Failing such designation by the parties, the arbitral tribunal shall apply the [*option 1: law*] [*option 2: rules of law*] [*variant 1: determined by the conflict of laws rules which it considers applicable*][*variant 2: with which the case has the closest connection*].

2. The arbitral tribunal shall decide as amiable compositeur or ex aequo et bono only if the parties have expressly authorized the arbitral tribunal to do so and if the law applicable to the arbitral procedure permits such arbitration.

3. In all cases, the arbitral tribunal shall decide in accordance with the terms of the contract and shall take into account the usages of the trade applicable to the transaction.

Remarks*Paragraph (1)**Law — Rules of law*

37. The first set of options in paragraph (1) reflects the diverging views expressed in the Working Group on whether the words “rules of law” currently used in article 28 of the Model Law should also be used in a revised version of article 33 of the UNCITRAL Arbitration Rules to replace the term “law” (A/CN.9/614, para. 122).

Conflict of laws rules

38. The second set of variants addresses the proposal made to replace the conflict of laws rules with a direct choice of the rules of law most closely connected to the dispute (A/CN.9/614, para. 123).

References to previous UNCITRAL documents*Paragraph (1)*

A/CN.9/614, paras. 122-123.

A/CN.9/WG.II/WP.143/Add.1, para. 30.

Paragraph (2)

A/CN.9/614, paras. 124

A/CN.9/WG.II/WP.143/Add.1, paras. 31

Settlement or other grounds for termination**Article 34**

1. If, before the award is made, the parties agree on a settlement of the dispute, the arbitral tribunal shall either issue an order for the termination of the arbitral proceedings or, if requested by both parties and accepted by the tribunal, record the settlement in the form of an arbitral award on agreed terms. The arbitral tribunal is not obliged to give reasons for such an award.

2. If, before the award is made, the continuation of the arbitral proceedings becomes unnecessary or impossible for any reason not mentioned in paragraph 1, the arbitral tribunal shall inform the parties of its intention to issue an order for the termination of the proceedings. The arbitral tribunal shall have the power to issue such an order unless a party raises justifiable grounds for objection.

3. Copies of the order for termination of the arbitral proceedings or of the arbitral award on agreed terms, signed by the arbitrators, shall be communicated by the arbitral tribunal to the parties. Where an arbitral award on agreed terms is made, the provisions of article 32, paragraphs 2 and 4 to 7, shall apply.

Remarks

39. No proposals for modification have been made in relation to article 34.

Interpretation of the award**Article 35**

1. Within 30 days after the receipt of the award, either party, with notice to the other party, may request that the arbitral tribunal give an interpretation of the award.

2. The interpretation shall be given in writing within 45 days after the receipt of the request. The interpretation shall form part of the award and the provisions of article 32, paragraphs 2 to 7, shall apply.

Remarks

40. No proposals for modification have been made in relation to article 35.

References to previous UNCITRAL documents

A/CN.9/614, paras. 125-126

A/CN.9/WG.II/WP.143/Add.1, para. 32

Correction of the award**Article 36**

1. Within 30 days after the receipt of the award, either any party, with notice to the other party parties, may request the arbitral tribunal to correct in the award any errors in computation, any clerical or typographical errors, or any errors or omissions of a similar nature. The arbitral tribunal may within 30 days after the communication of the award make such corrections on its own initiative.

2. Such corrections shall be in writing, and the provisions of article 32, paragraphs 2 to 7, shall apply.

Remarks*Paragraph (1)*

41. The word “omissions” has been added to take account of the proposal made in the Working Group to broaden the scope of article 36 to include correction of the award to cover situations such as arbitrator omitting to sign the award or to state the date or place of the award.

References to previous UNCITRAL documents

A/CN.9/614, para. 127

A/CN.9/WG.II/WP.143/Add.1, para. 33

Additional award**Article 37**

1. Within 30 days after the receipt of the award, ~~either a~~ a party, with notice to the other party, may request the arbitral tribunal to make an additional award as to claims presented in the arbitral proceedings but omitted from the award.

2. If the arbitral tribunal considers the request for an additional award to be justified and considers that the omission can be rectified [without any further hearings or evidence], it shall complete its award within 60 days after the receipt of the request.

3. When an additional award is made, the provisions of article 32, paragraphs 2 to 7, shall apply.

Remarks

42. The Working Group might wish to further consider whether the words “without any further hearings or evidence” should be deleted, and whether or not paragraph (2) could be understood as already allowing the arbitral tribunal to make an additional award after holding further hearings and taking further evidence (A/CN.9/614, para. 128).

References to previous UNCITRAL documents

A/CN.9/614, paras. 128-129
A/CN.9/WG.II/WP.143/Add.1, paras. 34

Costs (Articles 38 to 40)**Article 38**

The arbitral tribunal shall fix the costs of arbitration in its award.
The term “costs” includes only:

(a) The fees of the arbitral tribunal to be stated separately as to each arbitrator and to be fixed by the tribunal itself in accordance with article 39;

(b) The reasonable travel and other expenses incurred by the arbitrators;

(c) The reasonable costs of expert advice and of other assistance required by the arbitral tribunal;

(d) The reasonable travel and other expenses of witnesses to the extent such expenses are approved by the arbitral tribunal;

(e) The costs for [legal] representation and assistance of the successful party if such costs were claimed during the arbitral proceedings, and only to the extent that the arbitral tribunal determines that the amount of such costs is reasonable;

(f) Any fees and expenses of the appointing authority as well as the expenses of the Secretary General of the Permanent Court of Arbitration at The Hague.

Remarks

43. The modifications to subparagraphs (b)-(d) reflect the view expressed in the Working Group that the costs and expenses referred to under those subparagraphs should be qualified by the word “reasonable” (A/CN.9/614, para. 132). The Working Group might wish to determine whether the word “legal” in subparagraph (e) should be deleted.

References to previous UNCITRAL documents

A/CN.9/614, paras. 130-132
A/CN.9/WG.II/WP.143/Add.1, paras. 35-36

Article 39

1. The fees of the arbitral tribunal shall be reasonable in amount, taking into account the amount in dispute, the complexity of the subject matter, the time spent by the arbitrators and any other relevant circumstances of the case.

2. If an appointing authority has been agreed upon by the parties or designated by the Secretary-General of the Permanent Court of Arbitration at The Hague, and if that authority has issued a schedule of fees for arbitrators in international cases which it administers, the arbitral tribunal in fixing its fees shall take that schedule of fees into account to the extent that it considers appropriate in the circumstances of the case.

3. If such appointing authority has not issued a schedule of fees for arbitrators in international cases, any party may at any time request the appointing authority to furnish a statement setting forth the basis for establishing fees which is customarily followed in international cases in which the authority appoints arbitrators. If the appointing authority consents to provide such a statement, the arbitral tribunal in fixing its fees shall take such information into account to the extent that it considers appropriate in the circumstances of the case.

4. In cases referred to in paragraphs 2 and 3, when a party so requests and the appointing authority consents to perform the function, the arbitral tribunal shall fix its fees only after consultation with the appointing authority which may make any comment it deems appropriate to the arbitral tribunal concerning the fees.

Remarks

44. The Working Group might wish to further discuss whether the appointing authority should be given a wider role for the determination of the fees or whether it would be preferable to provide a more transparent procedure for agreeing on the method of calculating the arbitral tribunal's fees from the outset.

45. The Working Group might wish to note that the Permanent Court of Arbitration in the Hague has been approached on that matter and agreed to be involved to a greater extent in practical issues relating to the fixing of the fees, in accordance with a provision which could read along the following lines, and which would replace paragraphs (3) and (4): "The arbitral tribunal shall make a proposal setting out the principles according to which its fees are to be fixed, and shall subsequently specify the amounts established by applying those principles. At any stage, (a) the arbitral tribunal, or (b) any party, no later than 15 days after the proposal was made, may ask that the principles or the amounts of the fees, and, if applicable, the deposit, be established by the appointing authority or, if no appointing authority has been agreed upon or if the agreed appointing authority does not decide within thirty days of a party's request, by the Secretary-General of the Permanent Court of Arbitration at The Hague."

References to previous UNCITRAL documents

A/CN.9/614, paras. 133-134

A/CN.9/WG.II/WP.143/Add.1, para. 37

Article 40

1. Except as provided in paragraph 2, the costs of arbitration shall in principle be borne by the unsuccessful party [parties]. However, the arbitral tribunal may apportion each of such costs between the parties if it determines that apportionment is reasonable, taking into account the circumstances of the case.
2. With respect to the costs of [legal] representation and assistance referred to in article 38, paragraph (e), the arbitral tribunal, taking into account the circumstances of the case, shall be free to determine which party [parties] shall bear such costs or may apportion such costs between the parties if it determines that apportionment is reasonable.
3. When the arbitral tribunal issues an order for the termination of the arbitral proceedings or makes an award on agreed terms, it shall fix the costs of arbitration referred to in article 38 and article 39, paragraph 1, in the text of that order or award.
4. No additional fees may be charged by an arbitral tribunal for interpretation or correction or completion of its award under articles 35 to 37.

Remarks

46. Article 40 has been modified so as to be consistent with the proposed modifications to article 38 (e) (see above, paragraph 43).

References to previous UNCITRAL documents

A/CN.9/614, paras. 135

A/CN.9/WG.II/WP.143/Add.1, para. 38

Deposit of costs**Article 41**

1. The arbitral tribunal, on its establishment, may request ~~each~~ the parties to deposit an equal amount as an advance for the costs referred to in article 38, paragraphs (a), (b) and (c).
2. During the course of the arbitral proceedings the arbitral tribunal may request supplementary deposits from the parties.
3. If an appointing authority has been agreed upon by the parties or designated by the Secretary General of the Permanent Court of Arbitration at The Hague, and when a party so requests and the appointing authority consents to perform the function, the arbitral tribunal shall fix the amounts of any deposits or supplementary deposits only after consultation with the appointing authority which may make any comments to the arbitral tribunal which it deems appropriate concerning the amount of such deposits and supplementary deposits.
4. If the required deposits are not paid in full within 30 days after the receipt of the request, the arbitral tribunal shall so inform the parties in order that one or another of them may make the required

payment. If such payment is not made, the arbitral tribunal may order the suspension or termination of the arbitral proceedings.

5. After the award has been made, the arbitral tribunal shall render an accounting to the parties of the deposits received and return any unexpended balance to the parties.

Proposed additional provisions

Liability of arbitrators

Neither the arbitrators nor the appointing authority shall be liable to any person for any act or omission in connection with the arbitration, save for the consequences of conscious and deliberate wrongdoing.

Remarks

47. The Working Group might wish to consider whether the question of liability of arbitrators and institutions performing the function of appointing authority under the UNCITRAL Arbitration Rules should be addressed. In the affirmative, the Working Group might wish to consider the proposed draft provision, according to which arbitrators and appointing authorities should in principle be granted immunity, except in extreme case of “conscious and deliberate wrongdoing”.

References to previous UNCITRAL documents

A/CN.9/614, para. 131

A/CN.9/WG.II/WP.143/Add.1, paras. 39-40

General Principles

In the interpretation of the Rules, regard is to be had to their international origin and to the need to promote uniformity in their application and the observance of good faith. Questions concerning matters governed by these Rules which are not expressly settled in them are to be settled in conformity with the general principles on which these Rules are based.

Remarks

48. The provision seeks to address the suggestion made in the Working Group to include a provision on the interpretation of the Rules in accordance with their international origin in line with the new article 2A of the Model Law (A/CN.9/614, para. 121). The second sentence of that paragraph seeks to clarify that the Rules constitute a self-contained system of contractual norms and that any lacuna in the Rules is to be filled by an interpretation of the Rules themselves, without reference to any non-mandatory provision of applicable procedural law.

References to previous UNCITRAL documents

A/CN.9/614, paras. 120-121

A/CN.9/WG.II/WP.143/Add.1, para. 29

**E. Report of the Secretary-General of the Permanent Court
of Arbitration on its activities under the UNCITRAL
Arbitration Rules since 1976**

(A/CN.9/634) [Original: English]

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Introduction

1. At its thirty-ninth session (New York, 19 June-7 July 2006), the Commission agreed that Working Group II (Arbitration and Conciliation) should give priority to a revision of the UNCITRAL Arbitration Rules (1976) (“the UNCITRAL Arbitration Rules” or “the Rules”). The Working Group commenced its work on a revision of the Rules at its forty-fifth session (Vienna, 11-15 September 2006).

2. It has been considered appropriate to inform the Commission about the activities of the Secretary-General of the Permanent Court of Arbitration (“the PCA Secretary-General”) under the Rules, including to facilitate the current discussions on the revision of the Rules. The PCA Secretary-General has communicated to the Secretariat on 16 November 2006 a report providing a summary of its activities under the Rules since 1976.

3. It is recalled that articles 6, 7 and 12 of the Rules entrust the PCA Secretary-General, upon the request of a party, to designate an appointing authority for the purpose of appointing members of an arbitral tribunal and ruling on challenges to arbitrators. The PCA Secretary-General may also assist the parties in fixing the arbitrator’s fees and the arbitral tribunal in relation to deposit for costs in accordance with articles 39 and 41 (respectively) of the Rules.

4. The report of the PCA Secretary-General on its activities under the Rules is reproduced in substance below.

Report of the PCA Secretary-General on its activities under the UNCITRAL Arbitration Rules

1. Growth in the PCA appointing authority cases since 1976

5. Since the adoption of the Rules, the PCA Secretary-General has received requests to designate, or to act as, an appointing authority in over 270 cases (see attached annex). Twenty-five institutions and over twenty individuals have been designated by the PCA Secretary-General to act as appointing authorities. The most common request is for the designation of an appointing authority to appoint a second arbitrator on behalf of a defaulting respondent.

6. The significant growth in requests in recent years¹ is partially attributable to arbitrations commenced under bilateral and multilateral investment treaties.² Investment treaty matters have also contributed to the relatively high percentage of cases (approximately 40 per cent) in which a request was received where at least one State or State entity was involved. The PCA has also received an increasing number of requests to provide full administrative support in arbitrations under the Rules.

2. The procedure followed by the PCA Secretary-General in designating appointing authorities³

7. The PCA Secretary-General seeks to make the procedure as efficient as possible, and generally designates an appointing authority within two weeks of receipt of a request that contains all required documents.⁴

8. When the PCA Secretary-General receives a request to designate an appointing authority, he reviews the documents submitted to ensure that, on a prima facie basis, he is competent to act. Once satisfied, the PCA Secretary-General invites the respondent to provide its comments on the claimant's request within five to ten working days. After the respondent's comments have been received or the time

¹ In 2006, the PCA has received to date twenty-four requests.

² In 2005, seven requests for appointing authority services were received in connection with arbitrations commenced under investment treaties; sixteen requests were received in disputes arising under contracts.

³ The PCA has published (1) Procedural Guidelines for Requesting Designation of an Appointing Authority by the PCA Secretary-General under the UNCITRAL Arbitration Rules; (2) PCA Procedures for Cases under the UNCITRAL Arbitration Rules; and (3) Model Clauses for PCA Services under the UNCITRAL Arbitration Rules (see www.pca-cpa.org/ENGLISH/BD/ under the heading "UNCITRAL Rules and Procedures").

⁴ The documents required are: (1) a copy of the arbitration clause or agreement establishing the applicability of the UNCITRAL Arbitration Rules; (2) a copy of the Notice of Arbitration served upon the respondent, as well as the date of such service; (3) an indication of the nationalities of the parties; (4) the names and nationalities of the arbitrators already appointed, if any; (5) the names of any institutions or persons that the parties had considered selecting as appointing authority but which have been rejected; (6) a power of attorney evidencing the authority of the person making the request; and (7) payment of the non-refundable administrative fee of Euro 750 to the PCA.

limit to submit comments has expired, the PCA Secretary-General designates the appointing authority.

9. In making that designation, the PCA Secretary-General generally takes into account the following factors: (i) the comments of the parties; (ii) the nationalities of the parties and the regional or global character of the dispute (in order to select a neutral appointing authority); (iii) the place of arbitration, if specified; (iv) the language of the arbitration, if specified; (v) the complexity of the case and the amounts claimed; (vi) the fees charged by the prospective appointing authority; and (vii) the anticipated reaction time of the appointing authority. The PCA Secretary-General also ascertains the independence and impartiality of the appointing authority prior to designation.

10. The PCA Secretary-General emphasizes to the appointing authority that the designation is “for all purposes under the UNCITRAL Arbitration Rules” and therefore covers appointing arbitrators (articles 6 and 7), deciding challenges (article 12), and assisting with issues relating to arbitrator fees (article 39) as well as costs for deposits (article 41).

3. Noteworthy cases and trends

Replacement of appointing authorities

11. There has been an increasing number of requests to the PCA Secretary-General for the replacement of previously agreed appointing authorities pursuant to articles 6 (2) and 7 (2) (b) of the Rules.

12. For example, in one case, the claimant requested that the PCA Secretary-General replace the appointing authority on the ground of bias in favour of the respondent. Under the Rules, the only grounds for removal of an appointing authority are for failure or refusal to act. The PCA Secretary-General found that he was not empowered to remove the appointing authority on the ground advanced by the claimant and its request was denied. In another case, the claimant requested that the PCA Secretary-General replace an appointing authority on the ground that it had failed to act within the time limit provided for under article 7 (2) (b) of the Rules. The PCA Secretary-General examined the case and discovered that the claimant had not complied with article 8 (1) of the Rules, which required a party to provide an appointing authority with a copy of specified documents. The PCA Secretary-General’s view was that compliance with article 8 (1) was a condition precedent to the replacement of an appointing authority and the request was denied.

13. In yet another case, the claimant requested that the PCA Secretary-General designate a replacement appointing authority on the ground that the agreed appointing authority had failed to act. The agreed appointing authority, a national court judge, explained that the question of arbitrability of the dispute was pending before national courts and she declined to act until the issue was resolved. The PCA Secretary-General interpreted this as a refusal to act under the Rules, and designated a replacement appointing authority.

“Pathological” and problematic clauses

14. The PCA Secretary-General has received a number of requests to designate an appointing authority pursuant to arbitration clauses that are unclear or contain obvious drafting errors.

15. In one case, the claimant requested that the PCA Secretary-General designate an appointing authority to appoint the second arbitrator on behalf of a defaulting respondent. The arbitration clause provided that “[a]ny dispute or difference between the Parties [would be] referred to and determined by arbitration in The Hague under the International Arbitration Rules”. The respondent, when invited by the PCA to comment, objected to the claimant’s request on the ground that the clause was too vague to justify the competence of the PCA. The respondent also refused to agree to the application of the Rules. After reviewing the matter, the PCA Secretary-General informed the parties that he was not satisfied, on the basis of a *prima facie* screening of the documentation submitted by the parties, that he was competent to act.

16. The PCA Secretary-General has also been requested to designate an appointing authority in cases where the arbitration clause contains a reference to an administering body, and one of the parties objects to that administering body acting as the appointing authority. In such cases, the usual practice of the PCA Secretary-General is to designate the administering body referred to in the clause as the appointing authority, on the basis that the parties’ prior agreement was to choose that administering body.⁵

17. On one occasion, the PCA Secretary-General was requested to designate an appointing authority by a claimant who sought to invoke an arbitration clause in a bilateral investment treaty (“BIT”) between the respondent State and a third State by relying on the most favoured nation clause therein. The BIT provided for arbitration under the Rules and specified an appointing authority. The claimant was directed by the PCA Secretary-General to approach the appointing authority specified in the BIT regarding constitution of the tribunal.

4. Fee consultation

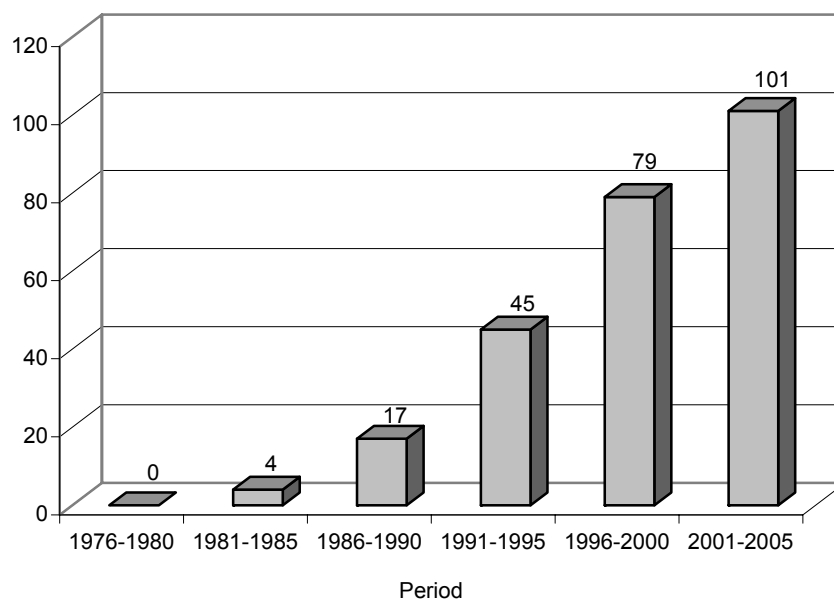
18. The PCA Secretary-General has assisted parties in reaching agreements with arbitrators with respect to their fees. It has coordinated a variety of fee arrangements, e.g., having the parties and arbitrators agree on fixed fees or to the fee schedule of an arbitral institution.

19. The PCA Secretary-General has also facilitated fee arrangements where the arbitrators charged different hourly rates. In some cases, co-arbitrators charge one hourly rate and the presiding arbitrator another. In one case, the PCA Secretary-General helped coordinate an arrangement whereby each arbitrator charged an individual hourly rate comparable to what they would normally charge in their home jurisdiction — such rates being significantly different from each other. The advantage of this approach is to avoid that all arbitrators charge at the highest rate.

⁵ For example, in a case, the arbitration clause provided that the proceedings would be “conducted under the Arbitration Rules of United Nations Commission on International Trade Law-UNCITRAL, in effect on the Effective Date and as administered by the London Court of International Arbitration”. The claimant requested that the PCA Secretary-General designate an appointing authority to decide a challenge. The PCA Secretary-General appointed the London Court of International Arbitration as the appointing authority.

Annex

Growth in the PCA appointing authority cases since 1976



IV. TRANSPORT LAW

A. Report of the Working Group on Transport Law on the work of its eighteenth session (Vienna, 6-17 November 2006)

(A/CN.9/616) [Original: English]

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Introduction

1. At its thirty-fourth session, in 2001, the Commission established Working Group III (Transport Law) and entrusted it with the task of preparing, in close cooperation with interested international organizations, a legislative instrument on issues relating to the international carriage of goods such as the scope of application, the period of responsibility of the carrier, obligations of the carrier, liability of the carrier, obligations of the shipper and transport documents.¹ The Working Group commenced its deliberations on a draft convention on the carriage of goods [wholly or partly] [by sea] at its ninth session in 2002. The most recent

¹ *Official Records of the General Assembly, Fifty-sixth Session, Supplement No. 17* and corrigendum (A/56/17 and Corr.3), para. 345.

compilation of historical references regarding the legislative history of the draft convention can be found in document A/CN.9/WG.III/WP.71.

2. Working Group III (Transport Law), which was composed of all States members of the Commission, held its eighteenth session in Vienna from 6 to 17 November 2006. The session was attended by representatives of the following States members of the Working Group: Algeria, Argentina, Australia, Austria, Belarus, Benin, Brazil, Canada, Chile, China, Colombia, Croatia, Czech Republic, France, Gabon, Germany, India, Iran (Islamic Republic of), Italy, Japan, Mexico, Nigeria, Pakistan, Republic of Korea, Russian Federation, Spain, Sweden, Switzerland, Thailand, Tunisia, Turkey, United Kingdom of Great Britain and Northern Ireland, United States of America and Venezuela (Bolivarian Republic of).

3. The session was also attended by observers from the following States: Bulgaria, Burkina Faso, Congo, Democratic Republic of the Congo, Denmark, Dominican Republic, Finland, Greece, Indonesia, Iraq, Latvia, Libyan Arab Jamahiriya, Malaysia, Netherlands, New Zealand, Norway, Peru, Philippines, Romania, Senegal, Slovakia, Ukraine and Yemen.

4. The session was also attended by observers from the following international organizations:

(a) **United Nations system:** United Nations Conference on Trade and Development (UNCTAD), United Nations Economic Commission for Europe (UNECE);

(b) **Intergovernmental organizations:** Council of the European Union, European Commission (EC), and Intergovernmental Organisation for International Carriage by Rail (OTIF);

(c) **International non-governmental organizations invited by the Working Group:** Association of American Railroads (AAR), BIMCO, Center for International Legal Studies (CILS), Comité Maritime International (CMI), European Shippers' Council (ESC), International Chamber of Commerce (ICC), International Chamber of Shipping (ICS), International Federation of Freight Forwarders Associations (FIATA), International Group of Protection and Indemnity (P&I) Clubs, International Multimodal Transport Association (IMMTA), International Road Transport Union (IRU), International Union of Marine Insurance (IUMI), and The European Law Students' Association International (ELSA).

5. The Working Group elected the following officers:

Chairman: Mr. Rafael Illescas (Spain)

Rapporteur: Mr. Walter de Sá Leitão (Brazil)

6. The Working Group had before it the following documents:

(a) Annotated provisional agenda and corrigendum (A/CN.9/WG.III/WP.71 and A/CN.9/WG.III/WP.71/Corr.1);

(b) A document on transport documents and electronic transport records presented for information by the Government of the United States of America at its seventeenth session, but consideration of which was not completed at that session (A/CN.9/WG.III/WP.62);

(c) A document on the limitation of the carrier's liability in the draft convention presented for information by the Government of China (A/CN.9/WG.III/WP.72);

(d) A document annexing comments and proposals of the International Chamber of Shipping, BIMCO and the International Group of P&I Clubs on topics on the agenda for the 18th session of the Working Group (A/CN.9/WG.III/WP.73);

(e) A document on the shipper's liability for delay presented by the Government of Sweden (A/CN.9/WG.III/WP.74);

(f) A note by the secretariat containing the revised text of chapter 16 of the draft convention on jurisdiction (A/CN.9/WG.III/WP.75);

(g) A document on rights of suit and time for suit in the draft convention on the carriage of goods [wholly or partly] [by sea] presented for information by the Government of Japan (A/CN.9/WG.III/WP.76);

(h) A proposal of the Government of the United States of America with respect to the procedure for the amendment of the limitation amounts in the draft convention (A/CN.9/WG.III/WP.77);

(i) A note by the secretariat on the relation of the draft convention on the carriage of goods [wholly or partly] [by sea] with other conventions (A/CN.9/WG.III/WP.78); and

(j) A document containing a drafting proposal by the Governments of Italy and the Netherlands with respect to the identity of carrier provision in the draft convention on the carriage of goods [wholly or partly] [by sea] (A/CN.9/WG.III/WP.79).

7. The Working Group adopted the following agenda:

1. Election of officers.
2. Adoption of the agenda.
3. Preparation of a draft convention on the carriage of goods [wholly or partly] [by sea].
4. Other business.
5. Adoption of the report.

I. Deliberations and decisions

8. The Working Group continued its review of the draft convention on the carriage of goods [wholly or partly] [by sea] ("the draft convention") on the basis of the text contained in the annexes to a note by the Secretariat (A/CN.9/WG.III/WP.56), and discussed various proposals and revised texts, including the proposal by the International Chamber of Shipping, BIMCO and the International Group of P&I Clubs on topics on the agenda for the 18th session of the Working Group (A/CN.9/WG.III/WP.73); the revised text of chapter 16 of the draft convention on jurisdiction (A/CN.9/WG.III/WP.75); the proposal of the Government of the United States of America with respect to the procedure for the amendment of the limitation amounts in the draft convention (A/CN.9/WG.III/WP.77); the proposal of the Governments of Italy and the Netherlands with respect to the identity of

carrier provision in the draft convention (A/CN.9/WG.III/WP.79). The Secretariat was requested to prepare a revised draft of a number of provisions, based on the deliberations and conclusions of the Working Group. Those deliberations and conclusions are reflected in section II below.

II. Preparation of a draft instrument on the carriage of goods [wholly or partly] [by sea]

Transport documents and electronic transport records — Chapter 9 *(continued)*

9. The Working Group was reminded that its most recent consideration of draft chapter 9 on transport documents and electronic transport records had commenced at its seventeenth session (see A/CN.9/594, paras. 216 to 233), but that it had been interrupted due to time constraints until the current session. It was also recalled that the most recent complete consideration of the topic by the Working Group took place during its eleventh session (see A/CN.9/526, paras. 24-61), and that a written proposal regarding the identity of the carrier in draft article 40 (3) had been submitted for the consideration of the Working Group for this session (see A/CN.9/WG.III/WP.79). The consideration by the Working Group of the provisions of chapter 9 was based on the text as found in annexes I and II of A/CN.9/WG.III/WP.56, and that the text of the provisions set out in A/CN.9/WG.III/WP.62 was the current text of the draft convention as found in A/CN.9/WG.III/WP.56, without modification.

Draft article 39. Signature

10. The Working Group considered the text of draft article 39 as contained in A/CN.9/WG.III/WP.56 and as reproduced in paragraph 19 of A/CN.9/WG.III/WP.62. It was recalled that draft article 39 had been accepted in substance at its eleventh session (see A/CN.9/526, para. 32) and that the only modification to the draft article since then had been to paragraph 2 to ensure that the text conformed with changes made to the text of the draft convention with respect to electronic communication (see A/CN.9/576, paras. 201-205).

11. The Working Group was informed that, in connection with informal consultations that took place in connection with draft article 39, it was suggested that the Working Group may wish to consider whether the draft convention should contain a definition of signature such as, for example, along the lines of that contained in article 14 (3) of the Hamburg Rules or article 5 (k) of the United Nations Convention on International Bills of Exchange and International Promissory Notes (see A/CN.9/WG.III/WP.62, para. 22). No support was expressed in the Working Group for the inclusion of such a definition. It was suggested that such a definition was unnecessary and that what constituted a signature could be determined according to practical commercial needs.

12. Support was expressed for the drafting proposal (see A/CN.9/WG.III/WP.62, para. 24) that the references to “authority” should be deleted from draft paragraphs (1) and (2). It was agreed that the consequences of unauthorized signature should be left to national law.

Conclusions reached by the Working Group regarding draft article 39:

13. After discussion, the Working Group decided that:
- The text of draft article 39 contained in A/CN.9/WG.III/WP.56 should be retained;
 - The expression “by the carrier or a person having authority from the carrier” in draft paragraph (1) be replaced by a phrase such as “by or on behalf of the carrier”; and
 - The expression “of the carrier or a person having authority from the carrier” in draft paragraph (2) be replaced by a phrase such as “of the carrier or a person acting on behalf of the carrier”.

Draft article 40. Deficiencies in the contract particulars

14. The Working Group proceeded to consider draft article 40 as contained in A/CN.9/WG.III/WP.56 and as reproduced in paragraph 25 of A/CN.9/WG.III/WP.62.

Paragraph (1)

15. It was noted that paragraph (1) provided a general rule that the absence of one or more contract particulars referred to in article 38 (1) or inaccuracy of those particulars did not of itself affect the legal character or validity of the transport document or the electronic transport record. The Working Group approved the substance of paragraph (1).

Paragraph (2) “shall be deemed to be”

16. It was recalled that paragraph (2) provided a rule to overcome ambiguity with respect to the significance of a date specified in the contract particulars. Clarification was sought as to whether the phrase “is considered to be” raised a rebuttable presumption or was conclusive in respect of interpreting a date included in the contract particulars. Support was expressed for the view that the phrase “is considered to be” should be taken as conclusive and that the paragraph could be revised to clarify that point, possibly by using a phrase such as “shall be deemed to be” in its stead.

Paragraph (3) and the identity of the carrier

17. The Working Group considered the text of paragraph 3 of draft article 40 as contained in A/CN.9/WG.III/WP.56 relating to transport documents and electronic transport records that were unclear with respect to the identity of the carrier. In connection with the discussion of draft paragraph 3, the drafting proposal set out in A/CN.9/WG.III/WP.79 was considered by the Working Group.

18. By way of introduction, it was explained that the various aspects of the drafting proposal contained in A/CN.9/WG.III/WP.79 were intended to deal principally with three perceived problems in connection with the identification of the carrier in transport documents and electronic transport records. The first problem was said to be when the face of the transport document or electronic transport record was unclear and contained, for example, only the trade names of the carrier or the name of the carrier’s booking agents, rather than identifying the carrier (see A/CN.9/WG.III/WP.79, para. 3). It was proposed that, in keeping with the identification of the carrier requirements of articles 23 (a)(i) and 26 (a)(i) of the

Uniform Customs and Practices for Documentary Credits 500 (UCP 500), draft paragraph 38 (1) (e) regarding the necessary contract particulars should be modified to read: “the name and address of a person identified as the carrier”. General support was expressed in the Working Group for this proposal, however it was recalled that the UCP 600 would soon be made public and should be reviewed to ensure the consistency of the draft convention in this regard.

19. The second practical problem intended to be addressed by the drafting proposal in A/CN.9/WG.III/WP.79 (see para. 4 thereof) was said to be the situation where the information in small print on the reverse side of a transport document in the so-called “identity of carrier” clause conflicted with the information identifying the carrier on the face of the document. In order to solve this ambiguity, it was proposed that a provision be inserted into the draft instrument (see A/CN.9/WG.III/WP.79, para. 4) ensuring that the information regarding the identification of the carrier on the face of the transport document or electronic transport record would prevail over contradictory information on the reverse side. Support was expressed for this proposal in the Working Group, with the caveat that care should be taken in the drafting of the provision to ensure that appropriate text was inserted to find an equivalent for the “reverse side” of an electronic transport record.

20. The third practical problem with which the drafting proposal in A/CN.9/WG.III/WP.79 was intended to deal was the situation when, despite existing requirements, the identity of the carrier remained unclear in the transport document or electronic transport record such as, for example, in the case where the document or record was signed by or on behalf of the master, without stating the basis of the master’s authority. In such cases, it was proposed that the fallback position for the identification of the carrier should be the text as set out in paragraph 5 of A/CN.9/WG.III/WP.79 whereby the registered owner was presumed to be the carrier, unless the owner identified the bareboat charterer, or unless the owner or the bareboat charterer defeated the presumption by identifying the carrier. A corollary of the acceptance of this aspect of the proposal was set out in paragraph 6 of A/CN.9/WG.III/WP.79, which provided for an extension of the limitation period for the commencement of actions by the claimant in such cases. It was stated that national law had in some cases provided a solution for this situation, but that the response in this regard was not uniform. Further, it was said that while presuming the registered owner to be the carrier might be inappropriate in cases where, for example, the owner was a financial institution, it was thought that the owner was nonetheless in the best position to identify the carrier, and thus to rebut the presumption.

21. General support was expressed in the Working Group for this effort to find a compromise solution to the persistent problem of the identification of the carrier. Further, support was expressed in principle for the particular approach to the problem that had been taken in the proposal.

22. However, concerns were expressed regarding the presumption that the registered owner of the ship was the carrier. It was thought that such an approach to the identification of the carrier could be particularly troublesome in the context of multimodal transport, where the registered owner of the ship might not have any knowledge regarding the other legs of the transport. Further, it was noted that the probability of the registered owner being the carrier was small, and that there was likely to be a series of charters from the registered owner, such that the owner may have very little knowledge regarding the identity of the carrier. It was also said to be

erroneous to assume that the registered owner could easily have access to the necessary information to rebut the presumption that it was the carrier.

23. It was said that there were additional complications related to the compromise approach to the identification of the carrier set out in paragraph 5 of A/CN.9/WG.III/WP.79. It was suggested that the presumption created in the proposal could reduce the flexibility of courts as they decided on the identity of the carrier responsible on a case-by-case basis by weighing all of the facts at hand, including the various indicators regarding the identity of the carrier on the transport document or electronic transport record, even though such indicators could conflict. Further, the concern was expressed that a provision such as the one proposed could prevent cargo interests from advancing their claims against the party they believed to be most responsible, and support was expressed for the suggestion that while deletion of the provision on the identity of the carrier was preferred, if it were retained, it was suggested that text along the following lines should also be adopted: "Nothing in this article prevents the claimant from proving that any person other than the registered owner is the carrier."

24. It was also indicated in the Working Group that the discussion had revealed a number of issues on which there was general agreement. The first of these was said to be agreement that the contracting carrier should be responsible for any breach of the contract of carriage. Further, it had already been agreed by the Working Group that draft article 38 should require the carrier to identify itself in the transport document or electronic transport record. It was noted that a presumption regarding the identity of the carrier was necessary only in situations where the carrier had failed to identify itself and left the consignee in the position of not knowing against whom to pursue its claim. Support was expressed for the view that while it was clear that the registered owner may not always have the best information regarding the identity of the carrier, it was likely to have some information regarding its ship, and the approach proposed to that problem was simply a device to allocate the burden of identifying the carrier and to give the consignee an effective remedy. It was also suggested that in order to deal with cases where there was a succession of charters of a vessel, the provision could be modified so as to allow each person in the chain of contracts to rebut the presumption that it was the carrier.

25. In further support of the proposed approach to the identification of the carrier set out in paragraph 5 of A/CN.9/WG.III/WP.79, it was indicated that a number of remedies relating to maritime law adopted a similar approach with respect to the responsibility of the registered owner of the ship, such as in the case of maritime liens or the arrest of a ship.

Paragraph (4)

26. The Working Group approved the substance of paragraph (4).

Possible additional paragraph: Number of originals

27. It was recalled that the Working Group had decided at its seventeenth session to include in draft article 38 regarding the required contract particulars the number of originals of a negotiable transport document issued (see A/CN.9/594, paras. 230 and 232-233). In that regard, the question was raised whether reference should be made in draft article 40 regarding the consequences of failure to include such information in the contract particulars. The Working Group agreed to leave this matter as a drafting issue to be decided by the Secretariat.

Conclusions reached by the Working Group regarding draft article 40:

28. After discussion, the Working Group decided that:
- The text of draft paragraph (1) be adopted;
 - The reference in draft paragraph (2) “is considered to be” is adjusted to render it conclusive;
 - The drafting proposals contained in paragraphs 3 and 4 of A/CN.9/WG.III/WP.79 should be adopted into the text of the draft convention;
 - The existing text of draft paragraph (3) should be maintained for the time being in square brackets;
 - In addition, the Secretariat should prepare revised text of the approach to the identity of the carrier issue in draft paragraph (3) based on principles as enunciated in paragraph 5 of A/CN.9/WG.III/WP.79 and the concerns raised by the Working Group during its consideration of that text;
 - Consideration of the proposal regarding the extension of the limitation period in which to take actions was deferred until the Working Group’s consideration of the revised text to be prepared regarding the identity of carrier problem;
 - The text of draft paragraph (4) be adopted; and
 - The Secretariat should prepare a new version of draft article 40 taking into account the above deliberations and conclusions.

Draft article 41. Qualifying the description of the goods in the contract particulars

29. The Working Group proceeded to consider draft article 41 as contained in A/CN.9/WG.III/WP.56 and reproduced in paragraph 35 of A/CN.9/WG.II/WP.62.

30. It was recalled that draft article 41 was based on the assumption that the shipper was always entitled to obtain a transport document or electronic transport record reflecting the information that it provided to the carrier but that in certain circumstances, a carrier should be entitled to qualify that information. The Working Group was informed that informal consultations had to some extent supported some of the drafting suggestions that had been made at its eleventh session (see A/CN.9/526, para. 37) but which had not been addressed in the text of the draft convention.

Distinction between containerized and non-containerized goods

31. One suggestion made was to either delete draft paragraph (b) and apply draft paragraph (a) to containerized goods, or to include text along the lines of draft article 41 (a)(ii) in draft paragraph (b) to address the situation in which the carrier reasonably considered the information furnished by the shipper regarding the contents of the container to be inaccurate (see A/CN.9/526, para. 37 and A/CN.9/WG.III/WP.62, para. 38).

32. In that respect, a question was raised as to the validity of distinguishing between containerized and non-containerized goods in draft article 41. Some doubt was expressed as to whether that distinction adequately reflected the current state of the industry, given that other means of transport, such as trailers, were sometimes used for goods as well. It was also suggested that paragraph (b) added a new element to the discussion, namely the term “closed”, and that it was not clear what

was meant by the term “closed container”, nor whether for example, a sealed door on a trailer could be considered a “closed container”.

33. In support of the current structure of the article, it was said that the distinction was valid for the reason that, in practice, containerized and non-containerized goods were treated differently, and that there was a presumption that a carrier would not open containerized cargo for inspection. The provision, it was further said, accommodated a wide range of practices, and the broad definition of the term “container” defined in article 1 (y) was sufficient to cover other types of unit loads, such as trailers. However, some support was expressed for combining draft paragraphs (b) and (c), as both paragraphs dealt with closed containers, although draft paragraph (b) dealt with quantity and description of the goods within a container, while draft paragraph (c) referred to the weight of the goods. In addition, a suggestion was made to include a reference to a description of the goods in paragraph (b) along the lines of that contained in article 38 (1) (a).

Requiring carrier to give reasons for qualification

34. Another suggestion made at the eleventh session was to require a carrier that decided to qualify the information mentioned on the transport document to give reasons for that qualification. That suggestion did not receive support.

Agreement by carrier not to include qualification in exchange for guarantee from shipper and the notion of “good faith”

35. A further suggestion was made to deal with the situation where a carrier agreed not to qualify the description of the goods in exchange for a letter of indemnity from the shipper, by providing sanctions and the loss of the right to invoke the limits of liability set forth in the draft convention when the carrier acting in bad faith voluntarily agreed not to qualify the information in the contract particulars. It was agreed, however, that questions of sanctions should be dealt with in provisions relating to the loss of the limitation on liability.

36. There was an extensive exchange of views on the notion of “good faith” in connection with the draft article. The use of the term “good faith” generally in the chapeau of article 41 was questioned not only because the concept of “good faith” had various meanings in different legal systems, but also because the explanation of what constituted “good faith” for the purposes of draft article 41, as set out in draft article 42, was felt to be too narrow. It was said, in that connection, that in legal systems that acknowledged a general obligation for parties to commercial contracts to act in good faith, a breach of such general obligation might also occur in a variety of situations not specifically mentioned in draft article 42.

37. Support was expressed for including examples of what “good faith” was, given that in circumstances where the carrier colluded with the seller it would be the consignee who would suffer as a result. However, strong support was expressed for the deletion of the term “good faith”. It was said that the term was susceptible to differing interpretations in different legal systems and that the term was not merely relative to a contract but applied to the behaviour of all the parties. It was also noted that its inclusion could be misinterpreted as implying that good faith was not required elsewhere in the instrument. It was suggested that one option might be delete the term “good faith” but include the elements in subparagraphs (b)(i) and (ii) of draft article 42 in a rule setting out the conditions for validity of qualifications made by the carrier under draft article 41.

“if the carrier can show”

38. Clarification was sought as to what was intended by the phrase “if the carrier can show” as used in draft paragraphs (a)(i) and (c)(i). It was suggested that if what was intended was that carrier could show to the seller or consignee then that should be expressly stated, but the view was also expressed that evidentiary matters should be left to national law, and that the references in these provisions to “can show” could simply be deleted.

Conclusions reached by the Working Group regarding draft article 41:

39. After discussion, the Working Group decided that:

- The term “good faith” in the chapeau in article 41 and the corresponding term in article 42 should be deleted with elements of the description contained in article 42 possibly being included at an appropriate place in article 41;
- The distinction between containerized and non-containerized goods should be maintained. However, consideration should be given to clarifying what was meant by a “closed container” to indicate that it referred to the situation where there was difficulty in inspecting the goods on the part of the carrier and streamlining paragraphs (b) and (c); and
- The Secretariat should prepare a new version of draft article taking into account the above deliberations and conclusions.

Draft article 42. Reasonable means of checking and good faith

40. It was recalled that at its eleventh session, the substance of draft article 42 was found to be generally acceptable (see A/CN.9/526, para. 43) and that in informal consultations since its seventeenth session, all of the delegates addressing the issue supported draft article 42 in substance as currently drafted (see para. 41 of A/CN.9/WG.III/WP.62).

41. It was agreed that issues addressed under draft article 41 should also be considered in relation to article 42 where relevant, for example, the decision to delete the reference to “good faith”.

42. A proposal was made to add the following wording at the end of paragraph (a): “and not require technical expertise or costs other than what follows from a customary examination of the goods”. It was suggested that if that proposal were accepted, then a consequential amendment would be to reword draft article 38 (1) (a) as follows: “The carrier is required to include in the transport document a description of the goods as provided by the shipper. However, the carrier is not obliged to include lengthy descriptions irrelevant to the contract of carriage or detailed technical descriptions of the goods which, even if controllable by the carrier, are not necessary in order to reasonably identify the goods or may impose an undue burden of control upon the carrier.” Whilst there was some sympathy expressed for the potential problem of increased burden on the carrier or of burdensome inclusions in the contract of carriage, the proposed additional text did not receive support. It was agreed that the matter sought to be covered therein was already encompassed by the phrase “commercially reasonable”. Possible concerns that the term “commercially reasonable” was too imprecise to encompass the intention of the proposal could be addressed, for instance, in a commentary on the draft convention that the Secretariat might wish to prepare.

43. It was noted that the decision to delete references to good faith in draft article 41 would entail deletion of paragraphs (b) and (c) of draft article 42. For that reason, it was suggested that the remainder of draft article 42 (paragraph (a)) could be inserted at the appropriate juncture in draft article 41.

Conclusions reached by Working Group regarding draft article 42:

44. After discussion the Working Group decided that:

- Paragraph (a) be included in a revised version of draft article 41; and
- In accordance with the decision to delete references to “good faith” in article 42, paragraphs (b) and (c) be deleted and the elements that characterized a carrier’s action in good faith to be possibly included in a revised draft article 41.

Draft article 43. Prima facie and conclusive evidence

General discussion

45. The Working Group considered the text of draft article 43 as contained in A/CN.9/WG.III/WP.56 and as reproduced in paragraph 42 of A/CN.9/WG.III/WP.62. It was recalled that draft article 43 had been accepted in substance at its eleventh session (see A/CN.9/526, paras. 44-48).

46. By way of introduction, the Working Group was reminded that draft article 43 set out the conditions, subject to draft article 44, under which transport documents or electronic transport records that evidenced receipt of the goods would constitute conclusive evidence of the carrier’s receipt of the goods as described in the contract particulars, and when they should be regarded as being only prima facie evidence of such receipt. The Working Group was in agreement with the text as set out in draft subparagraph 43 (a).

47. The Working Group agreed that the most controversial aspect of the provision was draft subparagraph 43 (b)(ii) with respect to the evidentiary effect of non-negotiable transport documents or non-negotiable electronic transport records. It was recalled that Variant A of draft subparagraph 43 (b)(ii) was slightly broader than Variant B, in that it did not restrict the protection it offered to third parties to those that had purchased and paid for the goods in reliance on the description of the goods in the contract particulars, and thus would include, for example, a bank that had relied on the contract particulars to advance money to the consignee.

48. The Working Group was reminded that a third variant of this subparagraph had been proposed as Variant C in A/CN.9/WG.III/WP.68, in order to take into account bills of lading consigned to a named person, which were approved by the Working Group for inclusion in the draft convention (see A/CN.9/594, paras. 208-211). The text of Variant C of subparagraph 43 (b)(ii), which was intended to replace Variants A and B, was proposed as follows (see A/CN.9/WG.III/WP.68, para. 21): “If a non-negotiable transport document or a non-negotiable electronic transport record that indicates that it must be surrendered in order to obtain delivery of the goods has been issued, if such document or record has been transferred to the consignee acting in good faith.”

Negotiable versus non-negotiable

49. By way of explanation of Variant C, the Working Group was reminded that the basic rule with respect to evidentiary value was that negotiable documents and records were considered conclusive evidence, while non-negotiable documents and records were considered prima facie evidence. The sole exception to this general approach was said to be sea waybills, to which the Comité Maritime International (CMI) Uniform Rules for Sea Waybills had been agreed to apply. In an effort to elevate the status and use of sea waybills, such documents were deemed conclusive evidence as between the carrier and the consignee. It was said that the primary objection to extending conclusive evidence status to non-negotiable documents and records in the terms set out in Variant A or B was that it was thought to be improper to confer such evidentiary status on the basis of a unilateral act by the consignee, i.e. the act of having relied on the description of the goods. It was suggested that bills of lading to named persons that included a presentation rule were deserving of the status of providing conclusive evidence, but that other non-negotiable documents and records were not. Some support was expressed for the approach set out in Variant C.

50. By way of further clarification, it was observed that the Hague Rules had originally conferred only prima facie evidentiary status on bills of lading or similar documents of title, and that the 1968 Visby Protocol had amended the Hague Rules to provide for conclusive evidentiary status. It was suggested that this amendment had been effected in order to address problems that had arisen because of the lack of uniformity in the application of the prima facie evidentiary rule in regard to bills of lading that had been transferred to third parties acting in good faith. In addition, it was noted that the 1968 amendment had referred only to bills of lading and had not extended to non-negotiable transport documents, because the scope of application of the Hague-Visby Rules was limited to bills of lading and similar documents of title.

51. Some doubts were raised as to whether the appropriate evidentiary weight of a document or record should depend on its negotiable status. It was suggested that there were four categories of documents which should be considered in this regard: negotiable documents and records, which should constitute conclusive evidence; documents and records which were mere receipts and which should not be conclusive evidence; bills of lading to named persons which were non-negotiable but which should nonetheless have the effect of conclusive evidence; and finally, non-negotiable documents and records that evidenced a contract of carriage, such as sea waybills. Of these categories, the evidentiary treatment of the first three was thought to be essentially non-controversial, but it was proposed that the final category could be treated in one of two ways: one option was to provide that unless otherwise stated on its face, the document or record constituted conclusive evidence, while the other option was to provide that unless otherwise stated on its face, the document or record constituted prima facie evidence only. Some support was expressed for a rule holding this fourth category of documents to be conclusive evidence unless otherwise stated on its face. In further support of this proposition, views were expressed that such a rule could also be appropriate in terms of promoting increased recourse to the use of sea waybills in circumstances in which a bill of lading was not necessary. However, some concerns were raised that this approach could cause legal uncertainty by allowing parties to change the legal nature of a document by including a certain statement in it.

52. An additional alternative approach to the problem of how to decide which documents and records should represent prima facie evidence, and which should

represent conclusive evidence, was also proposed. It was suggested that the distinction between documents and records based on their negotiable character should be abandoned in favour of an approach where the document or record would be considered *prima facie* evidence in all cases except those where three requirements were met: the relationship was between the carrier and a third party other than the shipper, and where the third party was acting both in good faith and in reliance on the description of the goods in the transport document or electronic transport record. Where those three requirements were met, the document or record would be considered conclusive evidence.

53. A strongly-held view remained that, with the sole exception of non-negotiable transport documents or electronic transport records that indicated that they had to be surrendered in order to obtain delivery of the goods, the *prima facie* evidence rule should be the general rule for non-negotiable documents or records such as sea waybills, while the conclusive evidence rule should apply only to negotiable transport documents and electronic transport records. It was said that any other approach risked causing significant confusion regarding the legal nature of the documents or records. Support for this view was said to arise from the basic rule that the transferor of a document or a record was not able to transfer to others greater rights than possessed by the transferor, and from the exception to that rule in the case of negotiable instruments, such as promissory notes or bills of lading, whose rights could be invoked from the face of the document or record itself. However, questions were raised whether this rationale unnecessarily intermingled concepts of the law of assignment with the evidentiary effect that the document or record, when functioning as a receipt, should have in respect of the protection of the rights of third parties acting in good faith.

54. A further observation was made that the question in issue should be less one of the law of assignment or of the strict consequences of negotiability, and more one of allocating the risk of relying on inaccurate information in the contract particulars as between the carrier, who possessed specialized knowledge and entered the information, and the innocent consignee. In this vein, the Working Group was urged to depart from the confines of strict domestic legal principle and to make a policy decision to allow non-negotiable documents or records to be considered conclusive evidence in certain situations in order to facilitate trade.

55. In urging the search for a compromise, it was noted that the contents of the contract particulars were dictated by the requirements set out in draft article 38, and that subparagraphs (1) (a), (b) and (c) thereof referred to information to be furnished by the shipper, which the carrier was under no explicit obligation to check. Further, it was observed that, since the carrier never checked the contents of containers in practice, the issue of whether a document or record was to be considered *prima facie* or conclusive evidence was of limited operation, since it did not apply to the container trade at all, and the two types of evidentiary value had similar practical effect.

Notion of “reliance” and “good faith” in relation to third party

56. In addition, concerns were raised regarding the requirement in draft subparagraph 43 (b)(ii) that the evidentiary value of a transport document or electronic transport record would depend on whether a third party had in fact relied on the description of goods in the contract particulars to its own detriment. This approach was said to be relatively unknown in civil law countries, and a preference was expressed for a more general solution linking the evidentiary value of the

transport document or electronic transport record to the function it fulfilled, possibly coupled with a general rule protecting the holder in good faith, in a manner similar to the law that governed negotiable instruments, such as bills of exchange and promissory notes, in many jurisdictions.

Conclusions reached by the Working Group regarding draft article 43:

57. After discussion, the Working Group decided that:

- While in agreement with respect to the text of draft paragraph 43 (a), the discussion of draft paragraph (b) indicated that the differences of approach with respect to the evidentiary treatment that should be conferred on certain transport documents or electronic transport records, be they negotiable or non-negotiable, had not yet sufficiently narrowed to allow for a consensus view to emerge in the Working Group; and
- Several different proposals had been made during the course of discussion, further to which the Secretariat was requested to prepare alternative draft text for consideration at a future discussion, taking into account the various views expressed in the Working Group.

Revised text of draft article 43

58. The Working Group recalled its earlier discussion of draft article 43 on prima facie and conclusive evidence, and its discussion of draft paragraph (b) which indicated differences in approach in the Working Group with respect to the evidentiary treatment that should be conferred on the information in certain transport documents or electronic transport records, be they negotiable or non-negotiable (see paras. 45-57 above). To resolve conflicting views expressed on paragraph 43 (b), a proposal was made to revise the text of draft article 43 as follows:

“Article 43. Evidentiary effect of the description of the goods in the contract

“Except as otherwise provided in article 44, a transport document or an electronic transport record that evidences receipt of the goods is prima facie evidence of the carrier’s receipt of the goods as described in the contract particulars; and

“(a) Proof to the contrary by the carrier in respect of any contract particulars relating to the goods shall not be permissible, when such contract particulars are included in:

“(i) A negotiable transport document or a negotiable electronic transport record that is transferred to a third party acting in good faith, or

“(ii) A non-negotiable transport document or a non-negotiable electronic transport record that indicates that it must be surrendered in order to obtain delivery of the goods and is transferred to the consignee acting in good faith.

“(b) Proof to the contrary by the carrier vis-à-vis the consignee, acting in good faith, shall equally not be permissible in respect of contract particulars relating to the goods included in a non-negotiable transport document or a non-negotiable electronic transport record, when such contract particulars are

furnished by the carrier. For the purpose of this paragraph the number and type of containers is deemed to be information furnished by the carrier.”

Amendments in the proposal

59. It was clarified that the reference to “contract particulars furnished by the carrier” in the proposal included all information listed in subparagraphs 38 (1) (d) to (f) (inclusive), as well as the new subparagraph to be added to draft article 38 (1) regarding the inclusion of the number of original documents issued. It was noted that, in relation to the final sentence of subparagraph 43 (b), some additional drafting might be necessary, such that information with respect to the number and type of containers would be deemed to have been provided by the carrier, whereas information as to the seals on the containers would be deemed to be provided by the shipper. To address those concerns it was proposed to add after the word “containers” in subparagraph (b), the words “, their identifying numbers and the information referred to in article 38, subparagraphs (1) (d) to (f) (inclusive),” as well as the number of original documents issued. Additionally a further sentence along the following lines was proposed to be added at the end of subparagraph (b): “The number of container seals is deemed to be information furnished by the shipper”. Those amendments received strong support.

60. It was noted that the chapeau of paragraph (a) had been modified to the simpler formulation of “proof to the contrary” from the “conclusive evidence” approach, which had been found to be problematic. Further, subparagraph (a)(ii) had been added to the text as representing what was thought to be a consensus in the Working Group regarding the appropriateness of including bills of lading consigned to a named person in draft paragraph (a) (see paras. 48, 49, 51 and 53 above).

61. It was explained that the intention of the proposal had been to preserve the status quo with respect to negotiable transport documents, and to provide a compromise approach for the evidentiary treatment of non-negotiable transport documents in order to bridge the differing views expressed in this regard earlier (see paras. 49-55 above). On this aspect, the main innovation was in draft paragraph (b), which set out the nature of the compromise by drawing a clear demarcation line distinguishing the evidentiary value of information in the contract particulars of non-negotiable transport documents based upon whether that information was provided by the carrier or by the shipper. It was said that in respect of information it furnished in such documents, the carrier should not be permitted to provide proof to the contrary with respect to the consignee, but that such proof should be permitted when such information was furnished by the shipper.

General discussion

62. While some lingering concerns were expressed regarding the replacement of the requirement of reliance on the information with a “good faith” rule, and some doubts were expressed regarding granting any sort of non-negotiable transport documents status in terms of the evidentiary rule, it was generally recognized that the proposal represented a positive development in terms of a compromise approach. Strong overall support was expressed in the Working Group for the approach taken in the revised text of draft article 43 as representing a sound compromise on which to continue discussion.

Subparagraph (b)

63. It was suggested that the practical operation of paragraph (b) of the proposed provision might be unclear in terms of what evidentiary effect the information in the contract particulars in a non-negotiable transport document would have if a carrier chose to make a reservation under article 41 (a)(ii) to shipper-provided information. In response, it was explained that if the carrier inserted a qualifying clause to the shipper information, such as “contents unknown” or “as provided by shipper”, the description of the goods would still be shipper-furnished, but if the carrier (believing that the shipper’s description was incorrect) inserted its own description clause based on article 41 (a)(ii), it would do so at its own peril, and that clause would be considered to be carrier-furnished information.

Inclusion of a “mere receipt”

64. A concern was raised that the definition of a transport document or electronic transport record in draft article 1 (n) was very broad and could include a mere receipt. The question was raised as to whether it was appropriate that a non-negotiable transport document that merely evidenced receipt should be covered in draft paragraph (b), given that a mere receipt was issued only as evidence of receipt as between the shipper and carrier and nothing more. A sea waybill, on the other hand, was a different type of non-negotiable document in that it evidenced the contract of carriage, and which identified the consignee. However, the view was expressed that mere receipts should sometimes be properly included in draft paragraph (b), depending on their nature. Further, it was noted that most domestic legal regimes contained a general principle preventing parties from presenting evidence contrary to statements made by them. Finally, it was observed that, under its terms, this draft paragraph was unlikely to operate frequently, since mere receipts would not often have a function in the relationship between the carrier and the consignee. However, some concerns remained regarding the inclusion of a mere receipt in draft paragraph (b), such that it would have an estoppel effect, in particular in respect of legal regimes that did not have a general rule preventing reliance by a party on its own statement, and a suggestion was made that an effort could be made to investigate whether it was possible to exclude mere receipts from inclusion in draft paragraph (b).

“furnished by”

65. An additional question raised was whether the term “furnished by the carrier” was sufficiently clear, and concerns were raised that it might raise difficulties of proof, since the carrier most often entered the information in the contract particulars. In response, it was said that being required to prove from whom the information came would not be too onerous under modern transport conditions. It was noted that, in the past, carriers often had shipper instruction forms which required the shipper to provide certain specific information, but that nowadays there were established patterns within the industry regarding who had to furnish certain information.

“by the carrier vis-à-vis the consignee”

66. A question was also raised as to why the operation of draft paragraph (b) was limited to “the carrier vis-à-vis the consignee”. In that respect, it was noted that a transport document only had to be signed by the carrier and that article 39 did not require the shipper to sign the transport document, yet the shipper would not under

the current provision be protected in the same way as the consignee. In response, it was noted that the position of the consignee was particular, since the consignee was involved in the transaction without having participated in the contract of carriage, but that the shipper did not require the same protection since it was involved in the contract of carriage and the provision of information in the transport documents.

Freedom of parties to increase evidentiary value of a document

67. In response to a question, it was suggested that pursuant to the draft convention, including draft article 94, parties would not be prevented from agreeing to upgrade the evidentiary value of a non-negotiable transport document by making a statement in that non-negotiable transport document that it was conclusive evidence. It was noted, however, that the parties could not downgrade the evidentiary status of a document, and that although such a statement on the face of a document could change its evidentiary value, it could not change the negotiable or non-negotiable status of the document itself.

Conclusions reached by the Working Group regarding revised text of draft article 43:

68. After discussion, the Working Group decided that

- The compromise proposal, as amended with respect to the closing line of paragraph (b), was acceptable in substance; and
- The Secretariat prepare a text taking account of the comments made for consideration at a future session.

Draft article 44. Evidentiary effect of qualifying clauses

69. The Working Group considered the text of draft article 44 as currently drafted and contained in A/CN.9/WG.III/WP.56 and as reproduced in paragraph 47 of A/CN.9/WG.III/WP.62, and an alternative text contained in paragraph 49 of A/CN.9/WG.III/WP.62. The Working Group was reminded that draft article 44 set out the practical effect of qualifying clauses that fulfilled the requirements of draft article 41, thus permitting the carrier's qualification to supersede the prima facie or conclusive evidence that would otherwise exist under draft article 43. It was further recalled that a view had been expressed at its eleventh session that draft article 44, in its current form, favoured the carrier because it allowed the carrier to rely on its qualifying clauses regardless of its treatment of the goods (A/CN.9/526, para. 50, see also paras. 49-52). The alternative text offered a narrower approach, permitting the carrier to rely on qualifying clauses only when it could demonstrate a chain of custody by delivering a container in substantially the same condition in which it had been received.

70. Some support was expressed in the Working Group for the alternative text reproduced in paragraph 49 of A/CN.9/WG.III/WP.62, as it was said to represent a commercial compromise that preserved a balance between the interests of shippers and carriers. It was further explained that the alternative text had been carefully crafted to permit qualifying clauses where they had previously seldom been allowed, but that care had been taken to ensure that the text did not broadly allow such qualifications without regard to the care that the carrier had taken with respect to the goods.

71. Strong support was expressed in the Working Group for the text of draft article 44 as currently set out in A/CN.9/WG.III/WP.56. In response to the concerns

expressed regarding the need to ensure that care had been taken by the carrier with respect to the goods, the view was expressed that the fact that qualifying clauses must fulfil the requirements of draft article 41 should be sufficient for that purpose, in addition to the fact that draft article 44 only allowed their operation to the extent that they qualified the description of the goods.

72. Clarification was sought as to the relationship between draft articles 41 and 44, and particularly whether draft article 44 was necessary in light of the phrase in draft article 41 that “the carrier does not assume responsibility for the accuracy of the information furnished by the shipper”. In response, it was explained that, whereas draft article 41 provided for the inclusion of a specific qualifying clause that met certain requirements, article 44 was thought to be necessary since it set out the legal effect of such a clause. It was also clarified that *prima facie* or conclusive evidentiary effect of the document or record was not completely superseded by the qualifying clause, since there was certain information in the document or record on which no reservations were allowed. However, a drafting suggestion was made that, given the Working Group’s preference for the text as it appeared in A/CN.9/WG.III/WP.56, consideration could be given to simplifying the text by merging article 44 into article 41.

Conclusions reached by the Working Group regarding draft article 44:

73. After discussion, the Working Group decided that:

- The text of draft article 44 be retained but that its drafting be revisited once the text of draft article 41 had been finalized, with consideration being given to merging draft article 44 into draft article 41.

Draft article 45. “Freight prepaid”

74. It was recalled that, notwithstanding the deletion of the proposed chapter on freight at its thirteenth session, draft article 45 from that chapter had been retained in the text of the draft convention in square brackets. The Working Group was reminded that the provision preserved the carrier’s right to collect freight from the consignee unless an affirmative statement, such as “freight prepaid”, appeared in the negotiable transport document or negotiable electronic transport record. It was further recalled that proponents of the draft article said its inclusion was primarily intended to protect and provide clarity for third party holders of transport documents, such as banks (A/CN.9/552, paras. 163-164).

75. The Working Group considered three options in relation to the treatment of draft article 45: to delete it entirely; to revise the article so as to conform in substance with article 16 (4) of the Hamburg Rules, or to retain the draft article in its current form.

Deletion of the draft article

76. Some support was expressed for the deletion of draft article 45. In that respect, it was suggested that given that the general conditions in which freight should be paid had been left to national law, it was not appropriate to address the circumstances when freight would not have to be paid in the draft convention. As well, it was suggested that the payment of freight was a commercial matter that should be left to be resolved by the parties.

Revision in conformity with article 16 (4) of the Hamburg Rules

77. There was some support for revision of draft article 45 in conformity with article 16 (4) of the Hamburg Rules. However, concern was expressed regarding that provision of the Hamburg Rules, since it contained a reverse presumption regarding payment of freight from that of draft article 45, such that the carrier's right to collect freight from the consignee under the Hamburg Rules was defeated unless an affirmative statement, such as "freight payable by the consignee", appeared on the transport document.

Retention of draft article

78. While it was generally thought that this provision addressed a practical problem but was not a core provision of the draft convention, support was expressed in favour of retaining the provision as currently drafted. It was said that the provision merely represented what was uncontroversial international practice, namely that if freight had been stated to be prepaid the carrier could not claim it from the consignee.

79. In additional support of retention of the draft provision, it was recalled that the draft provision was intended to solve two practical problems. First, if a transport document or electronic transport record contained the statement "freight prepaid" then it would clarify that banks (and third parties generally) would never become liable for freight; and it would defeat a shipper's unjustified defence to a carrier seeking to collect freight therefrom on the basis that a "freight prepaid" document was a receipt issued by the carrier evidencing that the freight had in fact been paid (see A/CN.9/WG.III/WP.62, para. 57). Support was expressed for the retention of the draft article on the basis that it addressed these practical problems.

Carrier's right of retention and other drafting proposals

80. It was noted that, whilst the draft article, as currently drafted, confirmed that a consignee or other third party did not have an obligation to pay the freight, it did not explicitly exclude the possibility of a carrier asserting a lien or right of retention so as to force the consignee or other third party to pay the freight in order to take delivery. Although some concern was raised regarding inclusion of the right to retention in this provision given the agreement of the Working Group to include it elsewhere in the draft convention (see A/CN.9/594, paras. 114-117), support was expressed for inclusion of text along the lines contained in paragraph 59 of A/CN.9/WG.III/WP.62 to address that situation.

81. It was explained that this provision had been historically limited to negotiable transport documents because it was with respect to them that problems had arisen. However, there was support for the proposal that the draft provision should be extended to cover both negotiable and non-negotiable transport documents and electronic transport records, but that this decision could require reconsideration following a decision by the Working Group on the text of draft article 43 on prima facie or conclusive evidence (in this regard, see the revised text and discussion thereon at paras. 58-68 above). In addition, it was suggested that draft article 45 could include a requirement that parties act in good faith along the lines contained in article 43.

Conclusions reached by the Working Group regarding draft article 45:

82. After discussion, the Working Group decided that:

- The text of draft article 45 should be revised:
 - By incorporating text along the lines of that contained in paragraph 59 of A/CN.9/WG.III/WP.62;
 - By broadening the language to cover both negotiable and non-negotiable transport documents; and
 - By considering the inclusion of a requirement that parties must act in good faith in conformity with article 43.

Shipper's obligations — Chapter 8

Draft article 31. Shipper's liability for delay

General discussion of the problem of liability for delay

83. The Working Group was reminded that it had most recently considered the topic of the shipper's liability for delay at its seventeenth session (see A/CN.9/594, paras. 199-207), and that it had previously considered the topic at its sixteenth session (see A/CN.9/591, paras. 133 and 143-147). It was also recalled that a document containing information relating to delay had been presented by the Government of Sweden (A/CN.9/WG.III/WP.74), and that written proposals on this topic had been submitted for the consideration of the Working Group for this session (see A/CN.9/WG.III/WP.73, paras. 24-27), and at its seventeenth session (see A/CN.9/WG.III/WP.67, para. 22 and A/CN.9/WG.III/WP.69, paras. 8 to 14). The consideration by the Working Group of the provisions on the shipper's liability for delay was based on the text as found draft article 31 in annexes I and II of A/CN.9/WG.III/WP.56.

84. The Working Group recalled that, under draft articles 28 and 30, the shipper was obliged to deliver the goods ready for carriage and to provide the carrier with certain information, instructions and documents. It was further recalled that the shipper's liability for delay, due to breach of those obligations, was regulated in draft article 31, while the carrier's liability for delay was regulated in draft article 22, which had last been considered by the Working Group at its thirteenth session (see A/CN.9/552, paras. 18-31). The Working Group was also reminded that, during its sixteenth session, it had decided that the liability for breach of the shipper's obligations should be generally based on fault with an ordinary burden of proof (see A/CN.9/591, para. 138). Two exceptions to this general rule were that the shipper would be held strictly liable for failure to inform the carrier of the dangerous nature of goods being transported or for failure to mark or label such goods accordingly (see draft article 33), or for loss or damage due to the inaccuracy of information and instructions actually provided to the carrier (see A/CN.9/591, paras. 148 to 150). It was also noted that the liability of the shipper in the present text of the draft convention was not limited, such that the shipper, if found liable, could be exposed to enormous and potentially uninsurable liability for any consequential damage as well as any physical loss that resulted from a breach of the shipper's obligations (see A/CN.9/WG.III/WP.69 generally, and para. 8, and A/CN.9/591, paras. 143-147). The Working Group recalled that, as a consequence of that concern, a proposal had been made at its seventeenth session that, in the

absence of an acceptable limitation on the shipper's liability for economic loss or consequential damages arising from delay, liability for economic loss or consequential damages arising from delay on the part of the shipper and of the carrier should be deleted from the draft convention (A/CN.9/WG.III/WP.69, paras. 8 to 14).

Treatment of delay in other conventions and jurisdictions

85. By way of introduction of A/CN.9/WG.III/WP.74, the Working Group heard that the Hague-Visby Rules did not contain provisions on the carrier's liability for delay, but that the Hamburg Rules did contain such a provision based on fault, and limited to an amount equal to two and one-half times the freight payable for the goods delayed (article 6 (1) (b)), but not exceeding the total freight payable under the contract of carriage of the goods by sea. Further, pursuant to the Hague-Visby and Hamburg Rules, the shipper may be liable on a fault basis for damage caused by delay (see articles 4 (3) and 12, respectively) or on a strict liability basis for loss, including that arising from delay, as a result of providing inaccurate information (see articles 3 (5) and 17 (1), respectively), or from failure to mark, label, or inform regarding dangerous goods (see Hamburg Rules, article 13 (2) (a)). It was further recalled that the liability of the shipper under these provisions was unlimited.

86. The Working Group was also reminded that, while liability for physical loss arising from delay was well known and already included in the draft convention, liability for pure economic loss or consequential damages arising from delay on the part of the shipper or the carrier was not a part of transport law in some legal systems. In those jurisdictions, pure economic loss or consequential damages could only be recovered when they were foreseeable, and when such recovery was referred to in the contract of carriage. It was suggested that inclusion of liability for such damages in the draft convention would constitute a major change to the status quo, and would thus have to be one of the issues in the draft convention that needed to be particularly carefully balanced in its treatment. In response to a question, it was clarified that the main concern of shippers with respect to their potential liability for delay was that their failure to provide timely and accurate information and documentation to the carrier, or that damage to the ship by the goods, could result in delaying the departure of the ship, and that the shipper responsible for the delay would be held liable on an unlimited basis for indemnifying the carrier for any amounts for which the carrier was found liable for delay to all of the other shippers with goods on board that ship.

Three possible options for dealing with delay

87. It was suggested that there were three possible approaches that could be taken in the text of the draft convention with respect to the treatment of liability for pure economic loss or consequential damages caused by delay on the part of the shipper or the carrier.

Option one: no liability for delay on the part of the shipper or the carrier

88. The first option was said to be to leave liability for delay completely outside of the scope of the draft convention, except for the liability for delay as a result of the submission by the shipper of inaccurate information. That approach would entail the deletion of all references to delay, which would mean that the question of liability for delay on the part of the shipper and of the carrier would be left to national law, and there would be no uniformity.

89. Some support was expressed for that approach. However, a disadvantage of this approach was said to be that some of the unimodal regional transport conventions, such as the Convention on the Contract for the International Carriage of Goods by Road, 1956, as amended by the 1978 Protocol (CMR) and the Uniform Rules concerning the Contract for International Carriage of Goods by Rail, Appendix to the Convention concerning International Carriage by Rail, as amended by the Protocol of Modification of 1999 (COTIF/CIM), contained provisions on liability for delay in delivery, which could create discrepancies in States that were parties to those conventions. An additional concern raised with respect to this approach was that in the modern transportation era, a key element was “just-in-time” delivery, which would not be taken into account by the draft convention if it were to remove all liability for delay. In addition, it was observed that simple deletion of all references to liability for delay on the part of the shipper in the draft convention would not necessarily absolve the shipper of liability for delay, given the shipper’s obligations set out in chapter 8, including the shipper’s liability for any loss caused by the goods or by breach of its obligations under draft article 31. If the shipper’s liability for economic loss should be left to national law, the entire chapter on shipper’s obligations, or at least draft article 31, should be deleted.

Option two: retain carrier liability for delay but delete shipper liability for delay

90. A second option was said to be to retain carrier liability for delay in the draft convention, but to delete shipper’s liability for delay and leave it to national law. This approach would leave the carrier with uniform limited liability, which was said to be of greater importance than uniform liability of the shipper for delay, since the primary obligation of the shipper under the contract of carriage was to pay the freight, while the primary obligation of the carrier was to deliver the goods. However, option two was still said to create an imbalance in the treatment of shippers and carriers.

91. In support of option two, it was said that liability of the shipper for delay had not been a great problem in practice. In response, however, it was observed that time was becoming increasingly important in modern transport, and as such, it could become a greater problem in the future. Further, it was noted that while, in theory, the carrier should not be responsible to all of the other shippers for one shipper’s delay, in practice, there was still a risk that the carrier would be held responsible to the other shippers, and would then look to the shipper at fault for compensation. Option two was thus said to be unacceptable because it would be unfair to impose broad liability on the carrier without providing the carrier with recourse against the party responsible for the delay. Additional concerns were raised regarding the importance of weighing the perceived benefits of including shipper liability for delay against the difficulty of proceeding with and proving such a claim, whether or not a limitation on liability was in place.

Option three: retain carrier and shipper liability for delay and find an appropriate limitation level for shipper liability

92. A third option was said to be to have the draft convention cover delay on the part of the carrier as well as on the part of the shipper. Some concern was expressed regarding the inclusion of shipper’s liability for delay, since it was thought that this could affect the non-liner trade where there were often damages for delay, and where it could further affect well-established contractual matters such as responsibility for demurrage and detention. Further, general concerns were

expressed regarding the possibility of creating burdens on the shipper that could be said to exceed those in the Hague-Visby or Hamburg Rules.

93. Some of the advantages of option three were thought to be that the approach would be a uniform one that would provide predictability, certainty and balance to the draft convention. The support expressed for variant three was largely premised on finding an acceptable limitation level for shipper liability. It was suggested, however, to clarify the notion of the words “loss” and “delay” used in draft article 31.

Possible methods to limit shipper's liability for delay

94. A number of suggestions were made in the Working Group regarding how best to establish an appropriate limitation level for the liability of shippers. In general, it was thought that an appropriate limitation level could be fairly low, since it was not the goal of the draft convention to provide full compensation for the economic loss in issue. Further, it was thought that the basis of the limitation level should be high enough to provide an incentive for a shipper to do its utmost to meet its obligations under the draft convention.

95. One approach that was suggested was to hold the shipper fully liable for physical loss, such as loss and damage to the ship and other equipment, but limiting the shipper's liability for pure economic loss to an amount equal to the value of the goods shipped. Disadvantages of this approach were thought to be that it could create a certain disparity, since cargo of low value could cause as much damage as cargo of high value, and that it could be difficult to establish the value of the goods. But an advantage was thought to be that it would be equitable that shippers of large volumes of more expensive goods would have to take on greater risk. A further advantage was said to be that the value of most commodities in the liner trade was quite stable over time, and a Special Drawing Rights (SDR) approach could be avoided.

96. Another possible approach to establishing a limitation level for shipper's liability was thought possible by linking it to the amount of the freight payable on the goods shipped, similar to the approach to limit the carrier's liability for delay in draft article 65. One problem with this approach was thought to be that freight rates varied considerably over time, and that this limitation amount was in any event likely to be too low.

97. It was proposed that a further possibility for establishing an appropriate limitation level for shipper's liability would be to use the same limitation of liability as for the carrier in the case of loss or damage to the goods as set out in draft article 64. While the situation of the liability of the shipper for delay could not be said to be the same as that of the carrier for loss or damage to the goods, the advantage of this approach was said to be that it would be fair, and that it was well known and predictable. It was observed that this approach had been taken in one domestic system, and that the results there had not been entirely successful.

98. An additional approach suggested for the establishment of a limitation amount was to simply take a fixed sum at a reasonably insurable rate. Again, the advantages of such an approach were thought to be certainty and predictability.

99. A suggestion was made that the limitation level established for the liability of the shipper should extend to all of its potential liabilities, including those for physical loss. That suggestion received some support. Another suggestion was to

include a provision outlining the circumstances in which that limit could be exceeded. This suggestion was not taken up by the Working Group, nor was a suggestion that demurrage should be linked to delay, and thus subject to a limitation level.

Conclusions reached by the Working Group regarding the treatment of liability for economic or consequential loss occasioned by delay:

100. After discussion, the Working Group decided that:

- The approach to the treatment of liability for pure economic loss or consequential damages caused by delay on the part of the shipper or the carrier set out as “option three” should be pursued as the optimal approach for the draft convention, subject to the Working Group’s ability to identify an appropriate method to limit the liability of the shipper for pure economic loss or consequential damages caused by delay.

Proposals regarding the identification of an appropriate limitation level for shipper liability for delay

101. The Working Group recalled its earlier decision that the approach to the treatment of liability for pure economic loss or consequential damages caused by delay on the part of the shipper or the carrier set out in “option three” (as described in A/CN.9/WG.III/WP.74 and discussed in paras. 92-93 above) should be pursued as the optimal approach for the draft convention, subject to the Working Group’s ability to identify an appropriate method to limit the liability of the shipper for pure economic loss or consequential damages caused by delay.

102. The Working Group was reminded that the proposal to retain shipper liability for delay was to accommodate those jurisdictions where liability for pure economic loss arising from delay on the part of the shipper or the carrier was not recognized unless foreseeable, and such recovery was referred to in the contract of carriage. In such jurisdictions carriers were concerned that, where a shipper was responsible for a delay, the carrier could nevertheless be found liable under the draft convention in respect of that delay to all of the other shippers with goods on board that vessel. Shippers in those jurisdictions were equally concerned about a potentially very high exposure to liability in a recourse action brought by the carrier.

103. It was proposed that any provision on carrier liability for delay should include clarification that the carrier would not be liable for loss or damage to the extent that it was attributable to an act or omission of another shipper. That proposal received support although a concern was expressed that such clarification was unnecessary and might be confusing, given that such an exclusion was already encompassed within the general principle contained in draft article 17 (1), which relieved the carrier of all or part of its liability if it proved that “the cause or one of the causes of the loss, damage or delay is not attributable to its fault or to the fault of any person referred to in article 19”. However, it was suggested that as draft article 17 could be subject to differing judicial interpretation which nevertheless found a carrier liable, perhaps for an overall failure to put into place systems to prevent such a delay, the clarification would still be helpful.

104. It was noted that the intention behind such a provision was only to create a limit in respect of economic loss due to delay but that that limit would not apply to physical or consequential losses due to breach of other contractual obligations such as failure to inform the carrier of the dangerous nature of goods being transported or

failure to mark or label such goods accordingly (see draft article 33) for which the shipper should be subject to strict unlimited liability (see para. 95 above). Further, the shipper would still be liable for consequential loss resulting from physical damage to the vessel, other cargo or personal injury, in respect of any breach of its obligations under articles 28, 30 and 32.

Possible limitation on shipper's liability for delay

105. Recalling the Working Group's earlier discussion on possible methods to limit the shipper's liability for delay (see paras. 94-100 above), it was suggested that a fixed sum of 500,000 SDRs could be considered. It was explained that the reason for proposing a fixed sum was that it had proven difficult to tie the limitation level to the weight or value of the goods or to the freight, as neither of these factors necessarily corresponded with the risk in question. For example, a shipper who shipped waste might cause the same amount of damage as a shipper who shipped electronic equipment. It was noted that, whilst this figure was somewhat arbitrary, the amount chosen was based on the average freight rates for a container of between 1,500 and 3,000 US dollars, and that the total amount of the limitation was thought to be sufficient to ensure shippers were fully liable for ordinary delay cases, but to protect them from excessive exposure in extraordinary cases.

106. It was suggested that insurers be consulted for their views on whether that figure suggested for the limitation was appropriate, or on whether a general limitation on all of the shipper's liability for pure economic loss would be more appropriate. It was suggested that it might be necessary to undertake a cost-benefit analysis of the proposal to determine whether the proposed limitation amount represented an insurable risk and whether or not it would affect freight rates and impact negatively on international trade. In response to a proposal that a general limitation for all liability of the shipper arising from delay might be more appropriate, it was said that such an approach might necessitate a higher limitation to accommodate the relatively remote chance of extraordinary losses.

Proposal regarding recoverability of damages

107. It was noted that the draft convention did not expressly refer to the issue, but that, as in various domestic jurisdictions, foreseeability and causality should be necessary elements for a successful claim for damages. It was said that the draft convention should contain a provision to clarify that the issue of recoverability of pure economic loss was not dealt with in the draft convention and was therefore referred to national law. To clarify such issues, a proposal was made to add an additional provision to the draft convention along the following lines: "Without prejudice to article 23, nothing in this Convention prevents the application of the rules regarding the scope of recoverable damages under the applicable law". It was suggested that that principle should be applicable to both carriers and shippers and that the Secretariat should examine how that principle would apply to the liability regimes covered under the draft convention.

108. A question was raised as to what was meant by the term "applicable law" under the proposal and whether it referred to the contractual law or the law of the forum. In that respect, it was suggested that, as the assessment related to economic loss, reference should be made to law of the forum. A suggestion was made that that question be left to interpretation by the courts. As well, a concern was raised that the proposal could have the effect that there would be no liability in respect of delay at all where, under the applicable law, there was no liability for economic loss.

Proposal on freedom of contract

109. A question was raised whether the limitation on the shipper's liability should be subject to freedom of contract. As noted below (see paras. 190-194 below), the Working Group decided during its consideration of draft article 65 (which dealt with limitation of liability for loss caused by delay of the carrier) to retain the phrase "unless otherwise agreed" in square brackets until the Working Group had decided whether or not liability for delay on the part of the shipper was to be included in the draft convention. It was proposed that, if draft article 65 permitted a carrier to include a clause in its bill of lading that excluded or reduced its liability for delay, that exclusion or limitation should automatically benefit the shipper by a proportionate reduction in its liability for delay. It was suggested that creating a two-way benefit in such a provision would enhance the acceptability of the phrase "unless otherwise agreed" in the text in terms of draft article 65.

The "package" of three proposals

110. It was said that the proposals to render the liability limit subject to freedom of contract and to limit unduly remote damages pursuant to applicable law were complementary. It was noted that article 23 set out a calculation for determining the compensation payable by the carrier in respect of loss or damage to the goods. It was noted that the carrier might also be liable for other losses, and that the proposed provision with respect to the preservation of national rules regarding the causality and foreseeability of damages made explicit what had been implicit under the draft convention.

111. While the Working Group expressed generally positive views about the entire package of three proposals regarding the establishment of a limitation on the shipper's liability for pure economic loss arising from delay, some concerns were raised regarding the proposal on freedom of contract. Some doubts were expressed about how the principle of proportionality would work in practice, particularly in situations where, for example, the contractual freedom was used to choose another measurement for the loss entirely. There was also some concern whether this approach would be appropriate in general, and it was said that it would be necessary to examine the proposed new text carefully.

112. There was support for the view that any text should make clear that the limitation on the shipper's liability did not extend to contractual obligations, such as demurrage or damages for the detention of a vessel arising out of a charter party. It was also agreed that no final decision on the proposals could be taken until a written text was available.

Conclusions reached by the Working Group regarding the three proposals pertaining to the limitation of the shipper's liability for delay:

113. After discussion, the Working Group decided that:

- On the basis of the above discussions, a written proposal on the issue of a limitation on the shipper's liability for delay should be prepared for consideration at a future session;
- In addition, text should be prepared both regarding the preservation of national rules with respect to the recoverability of pure economic loss, and with respect to the possibility of freedom of contract for the adjustment of the limitation on both the

shipper's and the carrier's liability, as linked with the term "unless otherwise agreed" in draft article 65.

Rights of suit — Chapter 14

114. The Working Group had before it chapter 14 comprising draft articles 67 and 68 as currently drafted and contained in A/CN.9/WG.III/WP.56 and an information document concerning this issue in A/CN.9/WG.III/WP.76. The Working Group recalled that it had exchanged preliminary views on the issue of right of suit at its ninth session (A/CN.9/510, paras. 58 to 59) and undertaken a detailed discussion on the issue at its eleventh session (A/CN.9/526, paras. 149 to 162).

115. Before turning to consider the draft chapter substantively, the Working Group considered the question whether its provisions should be retained at all. In that respect, it was recalled that at previous sessions of the Working Group there had been support for deleting the draft chapter altogether (see A/CN.9/WG.III/WP.56, footnote 237; and A/CN.9/526, paras. 152 and 157).

116. It was pointed out that the draft chapter attempted to offer uniform solutions for important practical issues for which various legal systems offered different solutions. It had, however, become apparent that the purpose of the chapter, however laudable, was overly ambitious and that it was unlikely that the Working Group could reach a consensus on the substance dealt with therein.

117. Although certain aspects of draft article 67 could be incorporated into the provisions set forth in chapter 6 regarding liability of the carrier, there was strong support for the deletion of chapter 14 from the draft convention. There were, however, expressions of regret that, by deleting the draft chapter, the draft convention would leave a number of problems relating to the right of suit for possibly diverging domestic laws. For example, often it might be wrongly assumed that the holder of a bill of lading had an exclusive right of suit. Also, in respect of a non-negotiable document, uncertainty would remain as to whether a person that was not party to a contract of carriage but had suffered damage, had a right of suit.

Conclusions reached by the Working Group regarding draft chapter 14:

118. After discussion, the Working Group decided that:

- Chapter 14 be deleted in its entirety;
- Certain aspects of article 67 could be considered for incorporation into chapter 6 (liability of the carrier).

Time for suit — Chapter 15

119. The Working Group had before it chapter 15 comprising draft articles 69 to 71 as currently drafted and contained in A/CN.9/WG.III/WP.56 and an information document concerning this issue in A/CN.9/WG.III/WP.76. The Working Group recalled that it had exchanged preliminary views on the issue of time for suit at its ninth session (A/CN.9/510, para. 60) and undertaken a detailed discussion on the issue at its eleventh session (A/CN.9/526, paras. 163 to 182). It was recalled that the need for the draft chapter had not been questioned in previous sessions of the Working Group.

Types of claims to be covered

120. The Working Group began its deliberations by considering the proper scope of the chapter, in particular what types of claims should be covered.

121. There was general agreement within the Working Group that the draft chapter should apply to claims relating to a contract of carriage arising under the draft convention. Other types of claims between the shipper, the carrier and the maritime performing party (for example, for unpaid freight) should remain unaffected by the draft chapter.

122. The Working Group proceeded to consider whether the limitation period should apply only to claims against the carrier or the maritime performing party, or should also extend to claims made against shippers. The Working Group was reminded that that issue had been considered at its eleventh session (see A/CN.9/526, para. 166).

123. Some support was expressed for restricting the scope of the chapter to claims made against the carrier and the maritime performing party, with the time for suit for all other claims being left to national law. In support of that approach, it was suggested that whilst claims against carriers, which in most cases related to cargo loss or damage, were largely standardized, potential claims against shippers, for instance, as a result of delay attributable to inaccurate information or of damage caused by dangerous goods to a vessel, might cover a much broader spectrum of situations. Such claims might therefore require extensive investigation on the part of the carrier, needing longer than ordinary cargo claims to be properly prepared. They should not, therefore, be subject to a limitation period under the draft convention.

124. Against such restriction it was suggested that the scope should, in the interests of predictability and equal treatment of all parties to a contract of carriage, cover claims against both carriers and shippers. It was said that differences in the nature of the claims that could be brought against shippers as compared to those that could be brought against carriers was not relevant given that the chapter did not require a case to be fully argued within the limitation period, but merely introduced a time period within which judicial or arbitral proceedings should be commenced.

125. The Working Group considered the arguments advanced in favour of both propositions. It eventually agreed that the draft convention should cover claims against both the carrier and the performing party as well as claims against the shipper.

Duration of limitation period

126. The Working Group then turned to the question of the appropriate time during which a suit might be brought. There was some support for the suggestion that different time limits should be provided depending on the nature of the claim. It was said that a longer period of time (possibly two years) would be appropriate with respect to claims against shippers given their likely more complex nature, while a shorter time period of one year could be adopted in respect of claims against carriers. The prevailing view within the Working Group, however, favoured the inclusion of one time period that applied to all parties. Support was expressed for the proposal to apply a limit of one year to all claims, since this was the period currently used in many jurisdictions. A longer period it was said, might impact negatively on settlement of claims, given the tendency observed in practice of delaying the submission of claims for settlement until shortly before the limitation

period expired. The prevailing view within the Working Group, however, was that the potential complexities arising in relation to claims against the shipper might be better taken into account by a limitation period of two years for all claims.

Draft article 69. Limitation of actions

127. The Working Group proceeded to examine the two variants of article 69 as contained in A/CN.9/WG.III/WP.56 and reproduced in paragraph 19 of A/CN.9/WG.III/WP.76. Several issues were considered in relation to article 69. It was noted that Variant A referred to the carrier or shipper being “discharged from liability” if judicial or arbitral proceedings were not instituted within one year. By contrast Variant B referred to “rights” (or “actions”) being “extinguished” (or “time-barred”) if judicial or arbitral proceedings were not commenced within one year.

128. The Working Group recalled that several substantive questions arose in choosing between the variants. It was recalled that the distinction between a “limitation period” and the extinguishment of a right had been discussed at a previous session of the Working Group and that the difference might affect the applicability of the time period or the choice of applicable law (A/CN.9/526, para. 167).

129. The Working Group heard differing views as to the manner in which the principle of a limitation period should be formulated. It was pointed out that there was no uniformity among legal systems as to the nature and effect of a limitation period. While in some legal systems the expiry of a limitation period typically extinguished the right to which the limitation period related, in other legal systems a limitation period only deprived the entitled party of the possibility to enforce its right through court action. Some legal systems applied both rules, depending on the nature of the claim, some being extinguished, while others became unenforceable. It was further pointed out that such a distinction had a number of practical consequences, such as whether a party to a contract whose claim was affected by the limitation period still retained the possibility of invoking its claim, even though time-barred, as a defence in order to obtain a set-off in a claim asserted by the other party to the contract. That possibility existed for claims that were only rendered unenforceable by a limitation period, but was not available when the underlying right was extinguished.

130. There was some support for adopting a rule to the effect that the claimant’s rights under the draft convention would be extinguished by the limitation period, and that, accordingly, the approach taken in Variant A should be adopted. This would mean, in practice, that the party whose right had been extinguished could not use that “time-barred” claim by means of a set-off. Prohibition of the use of “time-barred” claims by means of set-off was said to be supported by the precedent of other international instruments on carriage of goods, in particular the CMR and the Budapest Convention on the Contract for the Carriage of Goods by Inland Waterway, 2000 (CMNI), which expressly precluded set-off of time-barred claims.

131. However, the prevailing view was that draft article 69 should only affect the enforceability of the claimant’s right and that, accordingly, the approach taken in Variant B, subject to retaining only reference to “action” rather than “right” was preferable. That approach, which would preserve the claimant’s right to set-off, was said to be consistent with the solution adopted in the Convention on the Limitation Period in the International Sale of Goods. It also had the advantage of not preserving the parties’ right to choose whether or not to file a claim on the basis of

the party's assessment of the expected benefit, as compared to the costs of the claim. Without the possibility of set-off, parties might be enticed to file even uneconomical claims in order to protect themselves against the possibility of a claim by the other party to the contract.

132. The question was raised as to whether the limitation period provided in the draft convention would be capable of being suspended or interrupted and, if so, under what circumstances. It was said that various legal systems provided a number of possibilities for suspending or interrupting a limitation period, or even making the period start to run again from zero. Given the variety of solutions found under domestic law, there was support for the suggestion that that matter should be left to domestic law. In that connection, it was suggested that the draft convention could include a provision indicating which law should govern that question, in which case a choice should be made between the law applicable to the contract rather than the law of the forum. The Working Group was mindful of the diversity of domestic laws on the question of suspension or interruption of limitation periods, but was generally of the view that the draft convention should offer a uniform rule on the matter, rather than leave it to domestic law. The general agreement within the Working Group was that the draft convention should expressly exclude any form of suspension or interruption of the limitation period, except where such suspension or interruption had been agreed by the parties under draft article 71.

Conclusions reached by the Working Group regarding draft article 69:

133. After discussion, the Working Group decided that:

- Draft article 69 should extend to claims both against the carrier and the shipper;
- The time period be fixed at two years for both types of claims;
- Variant B, without references to extinguishment of "rights" should be used as a basis for expressing the principle of limitation period;
- No suspensions or interruptions of the limitation period should be allowed, except as agreed by the parties under draft article 71;
- The party whose claim was time-barred under draft article 69 should nevertheless retain the possibility of set-off; and
- The Secretariat should prepare a revised version of the draft article, taking into account the above considerations.

Draft article 70. Commencement of limitation period

134. The Working Group noted that draft article 70 which provided for the commencement date of the limitation period had been discussed at its seventeenth session (A/CN.9/526, para. 170). At that time, preference had emerged for a commencement date that was linked to the date of actual delivery rather than the date of delivery stipulated in the contract of carriage, supplemented by a rule that referred to the contractual date of delivery in cases where there was total loss of the goods. An outstanding question in this regard was thought to be whether the same commencement date should be used for claims against the carrier, the maritime performing party and the shipper.

Claims against the carrier and maritime performing party

135. It was generally agreed that the purpose of the provision was to provide certainty by way of an easily determinable commencement date on which a person wishing to bring a claim could bring such a claim, and a person against whom a claim might be made would know whether or not that claim was to be made, so that the expiration of the period would be equally certain and predictable.

136. The question was asked, however, as to whether it was sufficiently clear that the draft article intended to refer to the date of actual delivery. It was said that the cross-reference to draft article 11, paragraphs 4 or 5, on the period of responsibility, obscured that intention, to the extent that such cross-reference might link the notion of “delivery” for the purposes of draft article 70, to the provisions in the contract of carriage that defined the date of delivery. In that respect, it was noted that a court, in determining the question of what constitutes delivery, might refer back to draft article 11 in any event. The Working Group agreed that the draft article should only refer to “delivery”, without reference to draft article 11, paragraphs (4) or (5), since the notion of “delivery”, which was also used in a similar context in article 3 (6) of the Hague-Visby Rules and article 20 (3) of the Hamburg Rules, was well understood and had been amply clarified in case law.

137. A proposal was made that in the case of total loss of the goods, reference could be had to the date on which the carrier took over the goods as the commencement date instead of “completed delivery”. A further proposal was made to use the date on which the carrier took over the goods for the commencement date for both regular claims and cases of total loss. It was said that a reference to the date on which the carrier took over the goods, which should be stated in the contract particulars pursuant to draft article 38, subparagraph (1) (f)(i), would provide an objectively verifiable element for determining when the limitation period would commence and would better promote legal certainty than a reference to “delivery”, which might require a finding of fact. Further, it was thought that the decision of the Working Group to set the limitation period at two years would provide sufficient time to cover the earlier commencement date in this case. That proposal received some support, but a potential problem was thought to be that the limitation period would start running prior to the right to claim arising. Overall, the Working Group preferred to retain the well-known approach of the date of actual delivery as taken in the Hague-Visby Rules and in the Hamburg Rules on the basis that these represented well-tested formulations. However, there was support for future consideration of using the date that the carrier took over the goods as the commencement date in the case of total loss.

138. Some support was expressed for the text used in the Hamburg Rules in that it contained a reference to partial delivery not expressly dealt with in draft article 70 as currently drafted.

139. It was recalled that as currently drafted, article 70 contained a specific rule for situations of total loss of the goods, since in such cases there would obviously be no “delivery”. The default rule in the draft article tied the limitation period to the “[last] day on which the goods should have been delivered”. The view was expressed that the phrase “should have been delivered” might be ambiguous. In response, it was pointed out that the reference to the date when the goods “should have been delivered” was an accepted default provision for situations of total loss, as it made the contractual date of delivery, which should be verifiable from the contract particulars, the starting point for the limitation period. The reference to the

“last” day on which goods should have been delivered, it was further explained, had been included so as to accommodate situations where goods were not required to be delivered at a specific date, but within a certain time, such as in a particular week or month.

140. Some doubts were expressed as to whether the same commencement date should also apply for claims against a maritime performing party. The advantage of one uniform commencement period was that it was said to meet the practical concern of providing predictability and certainty. However some doubts were raised about a uniform commencement period starting before the maritime performing party had received or taken custody of the goods. Some considered that the limitation period should only commence as against maritime performing parties on the date on which damages could be sought. It was noted that whilst that might be true, given that the Working Group had decided on a two-year period and that the date referred only to the commencement of the limitation period, applying the same date would not be too onerous.

Claim against shipper

141. It was recalled that doubts had been raised as to whether the time of delivery was relevant for the limitation period for claims against the shipper (A/CN.9/526, para. 173). It was suggested that, given the different nature of claims that could be made against shippers compared to those that could be made as against carriers, a different commencement period should apply relating to the date on which damages occurred. Generally, it was said that in accordance with well-established principles of law, a limitation period only started to run when the relevant party against which the limitation period operated had accrued a claim against the other party. Given the greater diversity of possible claims by carriers against shippers, as compared to the more standard nature of cargo claims, the Working Group should attempt to devise specific rules. A general rule that referred to the time when the carrier’s claim against the shipper accrued could also be used, if the formulation of more specific rules was not deemed to be feasible. There was some support for that proposal.

142. The countervailing view, however, was that, in the interest of enhancing legal certainty and predictability it would be preferable to provide for the same commencement date for claims against the shipper as for those against the carrier. It was pointed out that in most cases acts by the shipper that might cause damage to the carrier, such as failure to provide information on the dangerous nature of the goods, or appropriate instructions for handling them, would typically occur well before the delivery of the goods, so that, in practice, the carrier already benefited from the fact that the limitation period would not commence before delivery of the goods. Furthermore, it was said that the date of delivery, which was a material event easily ascertainable, better promoted legal certainty than a reference to the time when the shipper breached its obligations or caused damage to the carrier, which would inevitably vary from case to case. The Working Group concurred with the latter view and agreed that the same commencement date should apply to both claims against the shipper and claims against the carrier.

Conclusions reached by the Working Group regarding draft article 70:

143. After discussion, the Working Group decided to:

- Retain the text in draft article 70 but revise it to remove references to article 11 and to take account of the wording in article 20 (2) of the Hamburg Rules; and

- Retain the term “last” and remove the square brackets.

Draft article 71. Extension of limitation period

144. It was observed that a provision that enabled parties to extend the limitation period existed under the Hague-Visby Rules (article 3 (6)) and the Hamburg Rules (article 20 (4)). It was noted that draft article 71 was largely based on the Hamburg Rules in that it permitted a person against which a claim was made to extend the limitation period by declaration any time during the running of the limitation period. It was noted that draft article 71 differed from the Hague-Visby Rules which required an agreement and might permit an extension even after the lapse of the limitation period.

145. In response to a question as to the form requirement for the declaration in article 71, it was pointed out that draft article 3 required the declaration to be in writing but also admitted electronic communications.

146. The Working Group considered the form requirement appropriate.

Conclusions reached by the Working Group regarding draft article 71:

147. After discussion, the Working Group decided that the existing text of draft article 71 should be maintained.

Draft article 72. Action for indemnity

148. The Working Group recalled that draft article 72 provided for a special extension of the time period with respect to recourse action so that, for example, the carrier had sufficient time to bring an action against a sub-carrier when the action against the carrier was brought immediately before the lapse of a limitation period. It was recalled that a similar rule existed in both the Hague-Visby Rules (article 3 (6 bis)) and the Hamburg Rules (article 20 (5)).

149. The Working Group had before it two variants (as contained in A/CN.9/WG.III/WP.56 and reproduced in A/CN.9/WG.III/WP.76, para. 47). It was noted that the variants provided for a different commencement date for the additional 90 days after the expiration of the period contained in article 69.

150. It was recalled that Variant B had been drafted to meet the concern of certain civil law countries where an indemnity action could not be commenced until after the final judgment was rendered. However, paragraph (a) of draft article 72 was said to adequately address that situation by referring to the time allowed by the applicable law in the jurisdiction where proceedings were instituted.

151. To enhance certainty, a proposal was made that a requirement for early notification to the person against whom a claim for indemnity might be sought should be included to allow that person to preserve evidence that might otherwise be lost during the period. It was suggested that that notice be provided within 90 days after the end of the limitation period and that that period not be subject to extension. That proposal received some support.

Conclusions reached by the Working Group regarding draft article 72:

152. After discussion, the Working Group decided that:

- Variant B be deleted; and

- Variant A be retained and revised to include possible variants relating to providing notice of the original action.

Draft article 73. Counterclaims

153. It was recalled that draft article 73 was based on the suggestion made at the eleventh session of the Working Group that the draft convention should address counterclaims and that these types of claims should be treated in a similar fashion to recourse actions (see A/CN.9/526, para. 177).

154. Concerns were expressed that, as drafted, draft article 73 was unclear and too broad. It was suggested that draft article 73 should be revised to limit it to counterclaims that were instituted for set-off. It was recalled that the Working Group had already decided in draft article 69 to retain a reference to “action” rather than “right” which would preserve the claimant’s right to set-off and thus that draft article 73, in its present form, was now otiose. It was agreed that the placement of such a provision on set-off would need to be considered by the Working Group at an appropriate stage.

Conclusions reached by the Working Group regarding draft article 73:

155. After discussion, the Working Group decided that:

- A revised version of draft article 73 dealing with a rule on set-off be prepared and that that version either be located in draft article 73 or at another appropriate place in the draft convention.

Article 74. Actions against the bareboat charterer

156. It was recalled that article 74 addressed the concern that the limitation period might expire before a claimant had identified the bareboat charterer that was the responsible “carrier” under draft article 40 (3). It was agreed that the text in article 74 be modified to take account of the Working Group’s decision to reformulate paragraph 40 (3) (see paras. 17-25 and 28 above) and that the revised version of draft article 74 be retained in square brackets for consideration at a future session.

Conclusions reached by the Working Group regarding draft article 74:

157. After discussion, the Working Group decided that the text in draft article 74 be retained in square brackets and be revised in accordance with its decision taken in relation to draft article 40 (3).

Possible additional article with regard to the removal of actions pursuant to draft article 80 (2)

158. The Working Group recalled that at its sixteenth session, a proposal had been made that the draft convention should provide for the treatment of the time limitation for suit in connection with the removal of actions pursuant to draft article 80 (2) (see A/CN.9/591, para. 57).

159. It was suggested that, in general, any action which could be removed under draft article 80 (2) would be a declaratory action to deny the carrier’s liability and would not include legitimate actions against the shipper such as a claim for liability under chapter 8 (see A/CN.9/591, paras. 57-59). The Working Group agreed that it

was not necessary to have a special rule in connection with the removal of actions pursuant to draft article 80 (2).

Conclusions reached by the Working Group regarding possible additional article:

160. After discussion, the Working Group decided no additional article was required in relation to removal of action.

Limitation of carrier's liability — Chapter 13

161. The Working Group was reminded that it had most recently considered the topic of the limitation of the carrier's liability at its thirteenth session (see A/CN.9/552, paras. 25-31 and 38-62), and that it had previously considered the topic at its tenth session (see A/CN.9/525, paras. 65-70 and 81-92). It was also recalled that a document containing information relating to delay had been presented by the Government of China (A/CN.9/WG.III/WP.72), and that written proposals on this topic had been submitted for the consideration of the Working Group for this session (see A/CN.9/WG.III/WP.73, paras. 29-36, and A/CN.9/WG.III/WP.77). The consideration by the Working Group of the provisions on the limitation of the carrier's liability was based on the text as found in annexes I and II of A/CN.9/WG.III/WP.56.

Draft article 64. Basis of limitation of liability

Paragraph (1)

162. It was noted that paragraph (1) of draft article 64 provided a method for calculating the limitation level of the liability of the carrier. As in the Hague-Visby and the Hamburg Rules, the approach contemplated that calculation on the basis of both a per kilogram and a per package basis of the goods lost or damage, allowing for limitation of liability based on the higher of the two amounts as calculated. It was further recalled that paragraph (1) provided for an exception when the "nature and value" of the goods lost or damaged had been declared by the shipper before shipment and included in the contract particulars, or when a higher amount had been agreed upon by the parties to the contract of carriage. The Working Group agreed that the final amount of the limitation on liability to be inserted into paragraph (1) should be considered as an element of the overall balance in the liability regime provided in the draft convention, and thus agreed to proceed with its consideration of paragraph (1) without making specific reference to numbers or amounts at this stage of the discussions. In addition, factors that were said to be worthy of consideration in this regard were the tacit amendment procedure for the level of the limitation on the carrier's liability as found in draft article 104 of the draft convention, which offered additional flexibility for future adjustments of the liability limits, and the rule for non-localized loss or damage found in paragraph (2) of draft article 64.

General comments

163. The Working Group was reminded of the general principle for which a limitation on the carrier's liability was included in the draft convention and in other transport conventions. It was said the primary purpose of such provisions on limitation of liability was to regulate the relationship between two commercial parties in order to entitle each of them to obtain a benefit. It was recalled that,

without the benefit of a limitation on liability, the carrier would be fully liable for all loss or damage, and that where such goods were in containers, the carrier would have no knowledge regarding their contents, thus potentially exposing the carrier to very high and unexpected risks. Rather than pay expensive insurance costs, and in order to share the burden of that potentially very high risk, the carrier would have to apportion it to every shipper through an increase in freight rates. By allowing for a limitation of the carrier's liability, this allocation of risk allowed the costs of both shippers and carriers to be reduced, with the trade-off that full compensation for high-level losses would not be possible. It was further observed that the aim of an appropriate limitation on liability would reduce the level of recovery for some claims to the limitation amount, but that it would not so limit too many claims. It was also noted that the optimal limitation level would be high enough to provide carriers with an incentive to take proper care of the goods, but low enough to cut off excessive claims, yet to provide for a proper allocation of risk between the commercial parties.

164. The view was expressed that the limits of liability provided in the Hague or Hague-Visby Rules have proven to be satisfactory. It was observed that the limitation on the carrier's liability that appeared in paragraph (1) allowed for a limitation level on a per package or a per kilogram basis, whichever was higher. It was recalled that the Hague Rules contained only a per package limitation, while the Hague-Visby and Hamburg Rules contained both per package and per kilo limitation provisions, but that each of those conventions predated the advent of modern container transport. The importance of this was said to be that prior to widespread containerization, most goods were shipped in a crate or a large wooden box that counted as one package, while with the widespread use of containers, the per package limitation level was instead based on the number of packages inside the container. This development in practice increased the amounts recoverable from the carrier, as compared with the per kilogram limitation level or pre-container per package limitation would have allowed.

165. In further support of the view that the limits of liability provided in the Hague or Hague-Visby Rules were satisfactory, it was said that the limitation levels of other transport conventions, such as the CMR or the COTIF/CIM conventions, were not directly comparable to those in the maritime transport conventions, since several of the unimodal transport conventions included only per kilogram limitation levels. Thus, it was said, while the per kilogram limitation level was much higher than the Hague-Visby level, in fact, the level of recovery was much greater under those conventions that allowed for a per package calculation of the limitation level. It was also said that certain other conventions, such as the Convention for the Unification of Certain Rules for International Carriage by Air, 1999 (Montreal Convention), at 17 SDRs, set a high limitation level in comparison with other transport conventions, but that it also contained provisions rendering its limitation on liability incapable of being exceeded, even in the case of intentional acts or theft, and that the freight payable for the mode of transport covered by those other transport conventions was much higher than under the maritime transport conventions. Further, it was observed that it could be misleading to compare the regimes from unimodal transport conventions, since each convention contained provisions that were particularly geared to the conditions of that type of transport. In this regard, it was noted that it would be helpful to obtain actual figures with respect to recovery in cases of loss or damage to the goods, and to what extent the per package and per kilogram limits had been involved in those recoveries, but that such information had been sought from various sources and was difficult to obtain. The view was also expressed that,

since the transport covered during the door-to-door carriage of the goods could be multimodal, that it might be useful to consider the limitation amounts of other unimodal transport conventions, particularly in reference to cases of non-localized loss or damage to the goods.

166. It was further observed that, through the method in which the goods were packed for shipment, the shipper could essentially unilaterally choose whether any claim for loss or damage would be on the basis of a per package or a per kilogram calculation. In addition, it was noted that while it was not an opportunity of which shippers often availed themselves; a shipper always had the option to declare the value of the cargo it was shipping, or to agree with the carrier on a different limitation level, and thus to avoid falling within the rules for the limitation of the carrier's liability set out in paragraph (1).

167. In further support of the adequacy of the liability limits of the Hague-Visby Rules, it was suggested that, in the bulk trade, the average value of cargo had not increased dramatically since the time of earlier maritime conventions, and that, in the liner trade, the average value of the cargo inside containers had not increased dramatically either.

168. Another strongly supported view, however, was that an increase in the liability limits under the Hague-Visby Rules would be appropriate. It was noted that since broad containerization had meant that cheaper goods could be transported in containers more economically than in the past, examination of figures such as the average value of goods over time could be misleading in attempting to decide upon an equitable limit for the liability of the carrier. It was also pointed out that the value of high-value cargo had increased over the past number of years, and that inflation had also clearly affected the value of goods and depreciated the limitation amounts since the adoption of existing maritime transport conventions, which had been negotiated decades ago. There was support for the view that those factors should be taken into account when considering at what level the limitation in paragraph (1) should be set, and that an increase in the limitation level in traditional maritime conventions should be considered by the Working Group. There were, however, diverging views as to the parameters for such an increase. While there were suggestions that only a moderate increase might be conceivable, there were also views that the liability limits should be based on the amounts set forth in the Hamburg Rules, or above them.

169. In addition to the historical and commercial issues discussed by the Working Group in its consideration of the factors involved in choosing an appropriate level for the limitation of the carrier's liability, the Working Group was encouraged to take into account certain additional factors. In particular, it was said that regard should be had to the need to ensure broad acceptability of the draft convention, such as through careful consideration of the level of the limitation on the carrier's liability in relation to earlier maritime transport conventions. There was support for the view that it was preferable to strike a middle ground in choosing an appropriate limitation level, which might require an increase from levels in historical maritime conventions.

170. A note of caution was voiced that setting the limitation level for the carrier's liability at the level set forth in the Hamburg Rules, which currently governed only a relatively small fraction of the world's shipping, would represent a significant increase for the largest share of the cargo in world trade, which was currently governed by the lower limits of the Hague-Visby Rules, or even lower limits, as was

the case in some of the world's largest economies. However, concern was expressed that anything other than increasing the level of the limitation from previous maritime conventions might be perceived as a move backwards rather than forwards.

171. Having heard those views, the Working Group concluded its discussions by emphasizing their merely indicative nature, at the present stage of the deliberations, and reiterating its understanding that any decision on the limit of liability was to be treated as an element of the overall balance in the liability regime provided in the draft convention.

“nature and value of the goods”

172. A question was raised about the use of the phrase “nature and value of the goods” in paragraph (1), and how that phrase differed from that of “a description of the goods” as found in draft article 38 (1) (a) regarding contract particulars. It was suggested that the term used in draft article 64 (1) should mirror that of draft article 38 (1) (a), since, it was suggested, use of a different term could cause confusion regarding the intention of the shipper with respect to the declared value of the goods. Some reservations were expressed regarding this analysis, as it was thought that since draft article 38 concerned what had been taken into the carrier's custody and what was being transported, rather than a specific declaration of value, a clear difference in the terms used should be retained. However, a suggestion to clarify the drafting and the terms used, possibly by simply deleting the reference to “nature”, received support in the Working Group.

Per package and per kilogram

173. Although the suggestion was made that a final decision on the liability limit might be facilitated by retaining only the weight of the goods as an element to calculate the carrier's liability, the Working Group generally agreed that both package and weight should be retained for the Working Group's further consideration.

Conclusions reached by the Working Group regarding draft article 64 (1):

174. After discussion, the Working Group decided that:

- The mechanism set out in draft article 64 (1) for calculating the limitation level for the carrier's liability was approved;
- The phrase “nature and value of the goods” should be adjusted in keeping with the text set out in draft article 38 (1) (a); and
- A final decision on the limitation level for the carrier's liability would be made on the basis of the entire package of rights and obligations contained in the draft convention.

Paragraph (2)

175. The Working Group next considered paragraph (2) of draft article 64, which contained two variants, both of which set out a special regime for the limitation level with respect to non-localized loss of or damage to the goods. The Working Group agreed to defer its consideration of that provision until it had concluded its

discussion at this session on the relationship of the draft convention with other conventions.

Conclusions reached by the Working Group regarding draft article 64 (2):

176. The Working Group agreed to defer its consideration of draft article 64 (2) until after its discussion of the relationship of the draft convention with other conventions (see paras. 236-238 below).

Paragraph (3)

177. It was pointed out that the origin of this paragraph could be traced back to the Hague-Visby Rules. The Working Group noted that paragraph (3) regulated the limitation of liability in terms of the number of packages or shipping units when using containers, pallets or other means of transport. It was noted that when originally drafted for the Hague-Visby Rules, packages were often quite large but that with containerization the size of packages were now typically much smaller. That meant that carriers, by virtue of the definition of packages, now faced a greater exposure to cargo liability in respect of a single container than at the time the Visby Protocol was adopted.

Conclusions reached by the Working Group regarding draft article 64 (3):

178. After discussion, the Working Group agreed that the existing text of draft article 64 (3) should be maintained.

Paragraph (4)

179. The Working Group noted that paragraph (4) provided that the SDR as defined by the International Monetary Fund should be used as the unit of account for the purpose of calculating the carrier's liability.

Conclusions reached by the Working Group regarding draft article 64 (4):

180. The Working Group approved the paragraph 64 (4) in substance.

Draft article 65: Liability for loss caused by delay

Variant A or B

181. The Working Group had before it two variants and proceeded to consider which was preferable. It was noted that there was little substantive difference between Variant A or Variant B. However, Variant A received greater support on the ground that it provided greater clarity.

182. The Working Group was reminded of the objections that had been raised in connection with the treatment of liability for delay in the draft convention and that, for countries that had raised such objections, either variant of draft article 65 was only acceptable if the draft convention would also contain an equivalent provision for the shipper's liability for delay.

Nature of loss covered by the draft article

183. With a view to facilitating its consideration of the draft article, the Working Group was invited to consider the various types of loss that might be caused by delay in delivery of goods and how each category would be dealt with under the

draft convention. Loss caused by delay was said to fall under essentially three categories. The first category was physical damage or loss of goods (for example, of perishable goods, such as fruits or vegetables). The second category was economic loss sustained by the consignee due to a decrease in the market value of the goods between the time of their expected delivery and the time of their actual delivery. The third category was pure economic loss sustained by the consignee, for example where an industrial plant could not operate because components and parts of an essential machine were delivered late.

184. It was noted that the first category of damage caused by delay was clearly outside the scope of draft article 65, as it was covered by the provisions on the calculation of compensation for physical loss of the goods in draft article 23. The third category of loss (pure economic loss) was said to fall clearly under draft article 65. However, as regards the second category (i.e. loss of market value), the situation was said to be unclear. The Working Group concurred with that analysis and with the need for making it clear that draft article 65 was only concerned with pure economic (consequential) loss and that decline in the good's market value was a type of loss that should be covered by draft article 23.

Limitation level for loss caused by delay

185. There was some support for the suggestion that the main parameter for establishing the carrier's liability for delay should be the same as the calculation of compensation for physical damage to the goods in accordance with draft article 23, paragraph (1), namely the market value of the goods at the place of destination. Moving away from the value of freight as a factor for calculating compensation was said to be justified by the fact that freight rates were subject to large fluctuations, with current rates being much lower than, for example, at the time the Hamburg Rules were adopted, in 1978. Maintaining freight as a factor would therefore mean affording the shipper and the consignee much lower protection than in the past.

186. Yet another proposal was to link the limit of liability to whichever was the lesser of the actual amount of the loss or two and one-half times the freight payable for the goods delayed or the total amount payable as freight for all the goods shipped. That proposal received some support and a suggestion was made that further research be undertaken on the utility of referring to the value of goods in determining liability for loss caused by delay.

187. The prevailing view, however, was that, in keeping with other existing instruments, the amount of freight payable on the goods delayed was a more suitable factor for calculating the carrier's liability for economic loss caused by delay, which might be entirely unrelated to the value of the goods. The freight, in turn, had a direct relationship to the obligation that a carrier failed to perform in the manner agreed. It was said that as market value was often completely unforeseeable, such a limit would impose an unreasonable risk on carriers which in turn would have a negative impact on shippers in terms of higher freight rates. It was noted that compensation for loss due to decline in market value was already dealt with in draft article 23, and if that provision was unclear it ought to be clarified.

188. There were various expressions of support for retaining the liability limit set forth in article 6 (1) (b) of the Hamburg Rules, namely two and one-half times the freight payable for the goods delayed. It was also pointed out that the limitation of liability should provide an incentive for carriers to meet their obligation to deliver in due time, and should not, therefore, be too low.

189. The countervailing and strongly supported view was that liability limit of one times the freight for economic loss caused by delay would be adequate. It was explained that a casual comparison of the liability limits set forth in the Hamburg Rules was misleading, as in practice, they would seldom lead to a recovery of two and one-half times the freight paid. In that respect it was pointed out that whilst the Hamburg Rules included a limit of two and one-half times the freight payable, the overall limit of liability, in accordance with article 6 (1) (b), was the total amount in freight paid for the shipment. In practice, that meant that in most cases the limit was often one times the freight. For example, a shipper might ship ten containers with a rate of 1,000 SDRs each and a delay on one container would impose liability of 2,500 SDRs but, in what was said to be the more common situation where all the containers were delayed, the limit would be one times the total freight amounting to 10,000 SDRs, and not 25,000 SDRs. Furthermore, it was suggested that the liability limits for delay in the Hamburg Rules applied to all types of liability for delay, whereas draft article 65 was limited to economic (consequential) loss. It was suggested that one times the freight was already a substantial exposure given that the carrier could be liable to a large number of shippers in respect of delay and therefore using freight as the liability limit provided sufficient incentive for a carrier to meet its obligation of timely delivery.

“unless otherwise agreed”

190. The Working Group proceeded to consider whether to retain the phrase “unless otherwise agreed”, which appeared in both variants A and B. It was recalled that the intention behind inclusion of that phrase was to permit contractual freedom in relation to the limits of liability in respect of economic loss caused by delay. Opinion was divided on whether or not to retain that phrase.

191. It was said that retaining that phrase would render one of the basic obligations of the carrier, namely to deliver in time, non-mandatory and would undermine the incentive of carriers to meet that fundamental contractual obligation. In favour of deletion, it was noted that the phrase was unnecessary given that if the parties agreed on a higher limit, that possibility was already recognized in chapter 20 and any agreement on a lower limit would be contrary to the provision regarding contractual freedom. There was strong support for the view that the phrase in question would, in practice, mean that shippers and consignees would be deprived of any compensation for delay, as carriers would routinely include in pre-printed transport documents standard clauses reducing liability for delay to a possibly insignificant amount. While this level of freedom of contract might be acceptable for volume contracts where both parties negotiated on equal footing, it would not be appropriate in other situations in liner transportation, where contracts of carriage were contracts of adhesion, and shippers had no fair opportunity to negotiate their terms.

192. There was also strong support for retaining the phrase in question, it was suggested that the qualification was based on mutual agreement between the parties rather than a unilateral declaration by the carrier and that shippers today often had sufficient bargaining power to negotiate better conditions. It was further suggested that commercial flexibility was important to permit parties to impose different limits on consequential loss appropriate to their needs and that that approach met with commercial practices. Moreover, eliminating party autonomy on the matter would amount to making the carriers into insurers of the timeliness of the arrival of goods shipped. That result would impact negatively in a highly competitive industry where

very low freights had been experienced in recent time. Shippers for whom timely arrival was so essential always had the alternative of shipping their cargo by faster means, such as by air, and paying an accordingly higher rate of freight.

193. Having noted the conflicting opinions on the matter, the Working Group agreed that a final decision on whether or not to retain the phrase should be postponed until the Working Group had decided whether or not liability for delay on the part of the shipper would be included in the draft convention. If retained, then that would tend in favour of deletion of the words so as to make that paragraph apply on a mandatory basis.

Conclusions reached by the Working Group regarding draft article 65

194. After discussion, the Working Group decided that:

- The text contained in Variant A was preferred and should be used as the basis for further discussions;
- That the term “unless otherwise agreed” be retained in square brackets for consideration at a future session;
- That any necessary clarification be made to draft articles 23 and 65 with respect to what types of damage were being covered by each provision; and
- That a decision on the appropriate limit of liability for the carrier in respect of consequential loss caused by delay be deferred pending the identification of a consensus regarding any limitation on the liability of the shipper for delay.

Draft article 66. Loss of the right to limit liability

Paragraph (1)

195. The Working Group was reminded that paragraph (1) of draft article 66 set out the conditions which would cause the carrier to lose the benefit of the right to limit its liability. Those conditions were fulfilled if the claimant proved that the loss of, or damage to the goods, or breach of the carrier’s obligation under the draft convention, resulted from a personal act or omission of the person claiming the right to limit liability, done either intentionally or recklessly and with knowledge that the loss or damage would probably occur.

196. It was observed that a provision of this type that allowed for the limitation level to be exceeded in certain circumstances was a common feature in transport conventions. General approval was expressed in the Working Group for the structure and approach of the text in paragraph (1).

“personal”

197. A number of delegations expressed great dissatisfaction with the inclusion of the word “personal” before the phrase “act or omission” in paragraph (1), believing that it made it too difficult for the cargo claimant to prove that the conditions for the provision had been fulfilled and thus for the carrier’s limitation on liability to be exceeded. The Working Group recalled that the issue of whether or not to include this term in the paragraph had been discussed at length during its thirteenth session, and it decided against overturning the decision that it made at that time (see A/CN.9/552, paras. 59-60 and 62).

“[or as provided in the contract of carriage]”

198. The Working Group considered whether to include the phrase “[or as provided in the contract of carriage]” in the text of paragraph (1). The view was expressed that the text could be deleted, since it was thought that the proper conclusion would be reached by those applying the provision regardless of the inclusion of that phrase. In particular, it was thought if the conditions of the paragraph were fulfilled, it would result in a decision that any limitation on liability could be exceeded, regardless of where that limitation was found, and whether or not that particular phrase appeared in the provision. However, concerns were raised that since the draft convention only allowed the parties to agree to increase their level of limitation of liability and not to decrease it, if the phrase were not included, confusion could be caused in some jurisdictions regarding whether or not a higher limitation on liability that was agreed upon should be allowed to stand, even when the conditions of paragraph (1) had been met. After discussion, the Working Group agreed that the square brackets around the text should be deleted, and the phrase should be retained in paragraph (1).

Drafting concerns

199. Concerns were raised regarding the interaction of draft article 64 and the drafting of draft paragraph 66 (1). In particular, since the phrase in the text of draft article 64 “in connection with” had been deleted in favour of the insertion of the phrase “the carrier’s liability for breaches of its obligations under this Convention”, the question was raised whether the revised text included cases of misdelivery of goods or delivery without presentation of the negotiable transport document or for misrepresentation in the transport document. Further, if those situations were not included in draft article 64, the additional question was raised whether these situations could ever result in a case where the carrier’s limitation amount could be exceeded pursuant to draft article 66, since there might never be any intent or knowledge on the part of the carrier.

Conclusions reached by the Working Group regarding draft article 66 (1):

200. After discussion, the Working Group decided that:

- The square brackets around the phrase “or as provided in the contract of carriage” should be deleted and the phrase retained; and
- The text of draft paragraph (1) was approved by the Working Group, subject to any drafting adjustments considered necessary by the Secretariat for clarification.

Paragraph (2)

201. The Working Group was reminded that paragraph (2) of draft article 66 set out the conditions which would result in the carrier losing the benefit of the right to limit its liability in case of delay in delivery. Those conditions were fulfilled if the claimant proved that the delay in delivery resulted from the personal act or omission of the person claiming the right to limit liability, done either intentionally or recklessly and with knowledge that the delay would probably result.

202. The Working Group approved the text of draft paragraph (2), with the understanding that a proposal had been made that if an appropriate limitation level were found for the shipper’s liability for delay, the Working Group should consider

a similar provision to draft paragraph (2) setting out the conditions pursuant to which that limitation level could be exceeded.

203. A drafting concern was raised regarding the phrase “if the claimant proves” in draft article 66 (2) in comparison with the phrase “if it is proved” found in the corresponding provision of the Hamburg Rules at article 8 (1) and of the Hague-Visby Rules at article 4.5 (e), since it was felt that this would place an extra burden on the cargo claimant.

Conclusions reached by the Working Group regarding draft article 66 (2):

204. The Working Group approved draft paragraph (2), bearing in mind that a parallel provision could be needed for the limitation level for the shipper’s liability, should such a level be identified.

Draft article 104: Amendment of limitation amounts

205. In light of the provision’s close relationship with the provisions in chapter 13 on the limitation of liability, the Working Group next considered draft article 104 on the amendment of the limitation amounts in the draft convention. The Working Group recalled that it had requested the Secretariat at its thirteenth session to prepare a specific amendment procedure for the rapid amendment of limitation amounts in the draft convention (see A/CN.9/552, para. 40). The Working Group had before it two texts of draft article 104: that prepared by the Secretariat and inserted into the text of the draft convention in A/CN.9/WG.III/WP.56, and that proposed as a revised version set out in paragraph 9 of A/CN.9/WG.III/WP.77.

206. The view was expressed that a provision such as that in draft article 104, whether it was the proposed revised text or the version set out in A/CN.9/WG.III/WP.56, was directly linked to the level of the limitation of the carrier’s liability. In particular, it was thought that if the amount of the limitation were set at a very high level, the procedure for its amendment should be very strict, but if the amount were set at a relatively low level, the procedure for its amendment should be less strict.

Introduction of the text in paragraph 9 of A/CN.9/WG.III/WP.77

207. By way of introduction of the changes suggested in the proposed revised text, the Working Group heard that, as set out in paragraph (1) thereof, draft article 104 was intended to be a specific amendment procedure to be followed only with respect to the amendment of the limitation on liability of the carrier set out in draft article 64 (1). Any other amendments to the draft convention would be undertaken in the normal course under general treaty law.

208. In paragraph (2) of the proposed revised text, it was proposed that the number of Contracting States required to request the amendment of the limitation amount should be one-half of the number of Contracting States rather than one-quarter. The view was expressed that this change would ensure that there was sufficient consensus and that there was a need for material change of the provision among the parties most affected, in particular, those representing a sufficient percentage of cargo volume or cargo value in transport covered by the draft convention. It was further suggested that paragraph (2) of the proposed revised text should provide for the amendment to be made at a meeting of all Contracting States and Members of the United Nations Commission on International Trade Law (UNCITRAL), since it

was thought that, under existing international private law, significant changes to concluded texts were often produced by the same multilateral bodies that had formulated the original text.

209. A further innovation of the proposed revised text was said to be found in paragraph (4), which avoided the strict and potentially politicizing mechanism of a vote in favour of the normal consensus-based procedures of UNCITRAL. In addition to greater flexibility, resort to a consensus-based approval mechanism was proposed as appropriate for the amendment procedure, given that that was the mechanism that was used for the adoption of the draft convention itself.

210. Draft paragraph (5) of draft article 104 as set out in A/CN.9/WG.III/WP.56 was thought to be unnecessary, and it had been deleted in the proposed revised text of the provision.

211. By way of further introduction, draft paragraph (5) of the proposed revised text was said to be important in order to lend some stability to the draft convention by limiting the frequency with which, and the amount by which, the limitation level could be amended. The proposed text suggested that the appropriate time period for requesting any amendment was seven years after the entry of the draft convention into force, and seven years after any prior amendment procedure. Further, the proposed text suggested that any single increase or decrease in the limitation level should be limited to twenty-one per cent, and that any limit could not be increased or decreased by more than two times the original amount, cumulatively.

212. Draft paragraph (6) of the proposed revised text set out a time period for the amendment's entry into force of twelve months after the date of its adoption by a sufficient number of Contracting States, which was suggested should be the same number as that ultimately agreed upon in draft article 101 as required for entry into force of the draft convention as a whole. Paragraphs (7) and (8) of draft article 104 as set out in A/CN.9/WG.III/WP.56 were said to have established an unnecessarily lengthy period for the coming into force of the amendment.

213. Draft paragraph (7) of the proposed revised text provided that Contracting States would have to denounce the amendment or be bound by it, rather than having adopted the approach in the text in A/CN.9/WG.III/WP.56 whereby Contracting States would have to denounce the entire convention. The approach in the proposed revised text was thought to be a more flexible one, that would allow States that, for example, had difficulties with approving the amendment internally in time for its entry into force, to nonetheless remain parties to the convention itself.

Preliminary reaction to the proposed revised text in paragraph 9 of A/CN.9/WG.III/WP.77

214. It was observed that paragraph (2) of the proposal envisioned three different groups of States attending any UNCITRAL session convened to consider a proposed amendment: Contracting States that were members of UNCITRAL; non-Contracting States that were members of UNCITRAL; and Contracting States that were non-members of UNCITRAL. The question was raised whether there was any precedent for such a mixed body to amend a convention. In response, it was said that the three types of States were included in the text because they constituted the usual members and observers that participated in consensus UNCITRAL deliberations, and that all Contracting States to the convention should also be included in any discussions regarding its amendment. Examples mentioned in this regard were the adoption of the Visby Protocol, which was not limited to a

conference of Contracting Parties, and the negotiation of the 1974 Convention on the Limitation Period in the International Sale of Goods. In response to an additional question on this point with respect to any precedent that could be identified for the adoption of a simplified amendment procedure by a group including non-Contracting States, mention was made of various conventions of the International Maritime Organization that contain specific amendment procedures that are agreed to by consensus.

Conclusions reached by the Working Group regarding draft article 104:

215. After a preliminary discussion, the Working Group decided that:

- More time was required to reflect upon the procedure outlined in draft article 104 in both A/CN.9/WG.III/WP.56 and A/CN.9/WG.III/WP.77; and
- Further discussion of the provision would be deferred until a later date.

Relation with Other Conventions: draft articles 27, 89 and 90

General discussion and draft article 27

216. It was recalled that the Working Group had previously considered the issue of the relationship of the draft convention with other conventions at its eleventh session (see A/CN.9/526, paras. 191-202), and that the Working Group had instructed the Secretariat to prepare conflict of convention provisions for possible insertion into draft chapter 19 during its discussion of draft article 27, also at its 11th session (see A/CN.9/526, paras. 245-250, particularly paras. 247 and 250). Those provisions were currently found in the text at articles 89 and 90. It was also recalled that a note by the Secretariat had been prepared on the relationship of the draft convention with other conventions (A/CN.9/WG.III/WP.78), and that it was intended to be read along with a previous note on the sphere of application of the draft convention that had been prepared by the Secretariat (A/CN.9/WG.III/WP.29). The consideration by the Working Group of draft articles 27, 89 and 90 was based on the text as found in annexes I and II of A/CN.9/WG.III/WP.56.

217. The Working Group heard a presentation from the International Road Union (IRU) that highlighted certain concerns of the IRU regarding the interaction of the draft convention with the CMR. According to the IRU, the draft convention created a competing legal regime to the CMR for the carriage of goods by road. While recognizing that draft article 27 of the draft convention attempted to harmonize the operation of the two conventions, the IRU contended that the combined operation of draft articles 27, 89 and 90 of the draft convention would require a Contracting Party of the CMR that wanted to accede to the draft convention to be in conflict with the provisions of the CMR. The view of the IRU was that the draft convention would operate contrary to the terms of article 41 (1) (b) of the Vienna Convention on the Law of Treaties, with respect to the modification of a treaty, and of article 1 (5) of the CMR, which prohibited Contracting Parties of the CMR from making any special agreements amongst themselves to vary the provisions of the CMR. It was argued by the IRU that any Contracting Party of the CMR would be in conflict with those provisions by ratifying the draft convention, since it was alleged that the door-to-door sphere of application of the draft convention necessarily entailed that the obligations of those Contracting Parties under the CMR would be varied or violated. Of further concern to the IRU was the operation of draft

article 27 of the draft convention, that, in the case of localized loss or damage to the goods, allowed for the operation of mandatory provisions of other conventions that specifically provided for the carrier's liability, limitation of liability or time for suit, which was said to be contrary to the mandatory nature of the whole of the CMR, pursuant to its own provisions (see CMR, article 41).

218. In response to those remarks, it was pointed out that some of the comments of the IRU were based on tentative provisions in the draft convention that were still subject to consideration by the Working Group. It was also observed that the membership of the Contracting Parties of the CMR did not coincide with the membership of the United Nations, and that it was for the Contracting Parties of the CMR to assess the extent of their treaty obligations under public international law. Finally, it was also emphasized that the type of contract of carriage contemplated for coverage by the draft convention was clearly of a different type than that covered by the CMR.

219. The Working Group proceeded to consider the alleged conflicts between the draft convention and other international conventions on the carriage of goods. As a preliminary matter intended to alleviate any perceived concerns with the relationship of the draft convention with other conventions, it was proposed that the text of draft article 89 be modified by replacing the phrase, "and that applies mandatorily to contract of carriage of goods primarily by a mode of transport other than carriage by sea" with the phrase, "to the extent that it applies mandatorily to the contract of carriage in question and cannot be overridden by this Convention." It was explained that this proposed change was intended to ensure that other transport conventions were applied only and to the extent that such application was truly necessary and when the draft convention could not be said to apply. The Working Group took note of that suggestion.

220. It was observed that the draft convention and the CMR each had its particular and discrete sphere of application, based on the type of contract of carriage contemplated for inclusion. It was indicated that the draft convention concerned the "maritime plus" contract of carriage with additional inland carriage, while the CMR concerned contracts for the carriage of goods exclusively by road. It was further observed that the operation of draft article 27 intended to respect and preserve the provisions of the existing conventions for inland carriage of goods relating to liability matters, and that the performing inland carrier would always be subject to its own unimodal inland liability regime, while the overall contracting carrier would be subject to the regime under the draft convention. The Working Group was encouraged to avoid placing too much emphasis on the possible conflict of conventions.

221. The focus of the problem of conflict of conventions was said to be the definition of the contract of carriage in various conventions. For example, it was said that the definition of "contract of carriage" in the draft convention was quite broad, and could include a fairly short sea leg and very long inland carriage. Further, the combined transport provisions of other conventions, such as article 2 of the CMR and article 38 of the Montreal Convention, apply those conventions to the entire carriage in certain cases, regardless of the fact that other modes of transport were involved. This appeared to set up a direct conflict of conventions with the draft convention, but the view was expressed that draft article 27 was the most appropriate mechanism through which to deal with such conflicts, subject to any necessary drafting adjustments.

222. It was suggested that a conflict of conventions arose in the case of transport conventions primarily when the provisions on scope allowed for an overlap in the types of contracts of carriage covered by the convention. In particular, the concern was said to be particularly problematic only when the scope provisions of unimodal transport conventions were read very generously. The view was expressed that the scope provisions of the draft convention were quite modest and precise compared with those of other conventions, and that further precision of the scope of the draft convention had been achieved by allowing for actions against only the contracting carrier and the maritime performing party, leaving inland carriers subject to their unimodal inland regimes. It was acknowledged that, in spite of these mechanisms, there could still exist cases where there was a conflict between the regimes applicable to the overarching umbrella contract of carriage and the unimodal contract of carriage, and that draft article 27 was intended to allow for coordination in those cases by having the draft convention give way to mandatory provisions in present or future conventions but only regarding carrier's liability, limitation of liability or time for suit. The reason for maintaining the priority of the draft convention with respect to all other issues was said to be a matter of utmost concern to the certainty of trade, in that treatment of the documentary aspects of the multimodal shipment had to stay constant and subject to the rules of the draft convention. Otherwise, it was suggested that instability would be created by, for example, having a negotiable transport document suddenly being transformed into a non-negotiable one under the CMR for the land leg of the transport. Similar arguments were said to exist for the preservation of the right to instruct with respect to the goods, and the right of control, in that, unlike under certain unimodal conventions, the shipper could under the provisions of the draft convention prevent a consignee that had not paid for the goods from nonetheless collecting them at the end of the transport.

223. Although there was general satisfaction with the approach to other conventions taken in draft article 27, and although there was general agreement that the Working Group had agreed on adopting a limited network approach in the draft convention (see A/CN.9/526, paras. 219-239), some concerns were raised regarding whether the scope of draft article 27 was broad enough to provide a complete remedy for the conflict of conventions. In particular, since draft article 27 referred only to mandatory provisions, the view was expressed that conflicts could also arise in the case of non-mandatory provisions, such as with respect to notice of damage provisions, and that draft article 27 did not provide a sufficient answer for those situations. As such, it was said that the provisions of the draft convention could be said to overlap with the unimodal transport conventions. A possible solution for the problem regarding non-mandatory provisions was said to be the addition of a provision that parties were deemed to opt out of non-mandatory provisions of other conventions to the extent that they were in conflict with provisions of the draft convention.

224. Another, related problem was said to exist in the wording of draft article 27 (1) (b)(i) itself, which referred to conventions which according to their terms "appl[ied] to all or any of the carrier's activities" under the contract of carriage. It was pointed out that, given the differing scopes of application of the various unimodal transport conventions, their provisions might never apply "according to their terms" and draft article 27 might never operate, thus establishing a uniform system rather than a limited network system. It was suggested that the phrase "according to their terms apply to all or any of the carrier's activities under the contract of carriage during that period" should be deleted and replaced with text

along the following lines: “would have applied if the shipper had made a separate and direct contract with the carrier in respect of the particular stage of transport where the loss or damage occurred”. It was said in further support of a limited network system that it would operate in order to create the preferable situation in which the contracting carrier would be sued by the cargo claimant rather than the performing carrier.

225. The view was expressed by some that draft article 27, perhaps with some drafting adjustments to take into account the specific problems of overlap with conventions such as the Montreal Convention, was sufficient to ensure a solution to any potential conflict of conventions. In light of this, it was said by some that the additional provisions in draft article 89 and 90 were unnecessary, and in fact complicated the clear and predictable approach to the problem provided for in draft article 27. In support of this view, it was said that draft article 89 allowed too much discretion for a decision regarding which convention to apply to be made, and preference was expressed for the more certain approach presented in draft article 27. Further, it was said that using draft article 89 as a solution to the conflict of conventions problem would not provide as precise and uniform an interpretation as could be found by relying on draft article 27. However, others that supported draft article 27 saw a possible continuing role for draft articles 89 and 90, in order to deal with situations such as the direct and unavoidable conflict between the provisions of the draft convention and the operation of the provisions of other conventions, such as articles 18 (4) and 38 of the Montreal Convention. Further, it was thought that the position of draft articles 89 and 90 in the chapter on “Other conventions” was more appropriate for a conflict of conventions provision, and that inclusion of such provisions could provide added security of interpretation should such conflicts arise.

“[national law]”

226. Several delegations expressed the view that the phrase “national law” should be deleted from the chapeau of draft article 27 (1) (b). In support of this view, it was said the deletion of the terms would promote uniformity of interpretation and legal certainty. It was further suggested that the added complexity and expense in a cargo claim of having to determine the applicable provisions of national law argued against retention of that phrase. However, a considerable number of delegations also expressed a desire to retain the text in square brackets, pending further consideration of that phrase. In support of that proposal, the view was expressed that in some situations where the last leg of the carriage was by road and was purely domestic, leaving out the phrase could result in a markedly different regime being applied to that road leg than might be applied under domestic law. It was thought that further consideration should be given to such a possible scenario, or whether such concerns could be accommodated by means of another approach in the draft text.

An additional drafting concern

227. Questions were raised whether it was necessary in draft article 27 (1) (b)(iii) to make reference to “private contracts”, or whether the word “private” could be deleted from the text.

Conclusions reached by the Working Group regarding draft article 27:

228. After discussion, the Working Group decided that:

- The scheme of draft article 27 should be maintained with some possible drafting improvements;
- The brackets around the text of paragraph 1 should be removed and the text retained;
- The Secretariat was requested to consider alternative drafting for aspects such as the phrase “according to their terms apply”;
- To maintain the square brackets around paragraphs 2 and 3; and
- The phrase “[or national law]” in the chapeau of draft article 27 (1) (b) should be retained pending further consideration.

Article 89. International instruments governing other modes of transport and

Article 90. Prevalence over earlier conventions

229. The Working Group continued its discussion of the relationship between the draft convention and other conventions on the basis of draft articles 89 and 90, which, it was recalled, had been included in the draft convention at the request of the Working Group during its eleventh session (see A/CN.9/526, paras. 245-250, particularly paras. 247 and 250), but had not yet been considered by the Working Group.

230. Concern was expressed that draft articles 89 and 90 seemed to contradict each other, such that draft article 89 would allow for the prevalence of other conventions over the draft convention in cases of conflict, while draft article 90 provided for the prevalence of the draft convention over all other conflicting earlier conventions. In light of this, two possible solutions were suggested: the deletion of one or the other of draft articles 89 or 90, or the deletion of both provisions. In this regard, it was suggested that draft article 27 presented a satisfactory solution to the problem of any potential conflict between other unimodal transport conventions and the draft convention, and that no additional provision in this regard was necessary or desirable.

231. Other views were expressed in support of the proposal to delete draft articles 89 and 90 and to allow draft article 27 to stand, along with specific conflict of convention provisions in the draft convention at draft articles 79, 91, 92, 93 and the denunciation provision in draft article 102, as the sole provisions intended to resolve any potential conflict of conventions. In support of this proposal, the view was reiterated that, in terms of other unimodal transport conventions, such as the CMR, there was no conflict with the draft convention because the scope of application of those conventions was tied to contracts of carriage that were different from the “maritime plus” contract of carriage covered by the draft convention (see para. 225 above). Thus, it was said, the subject matter of those conventions and the draft convention was not identical. Secondly, it was said that draft article 27 had been drafted at the outset as a limited network approach to fulfil the role of a conflict of conventions provision, and that separating it from that conflict of conventions role could result in the broad application of draft article 27 to all inland carriage contemplated under the draft convention. It was said that such an interpretation could result in a significant decrease in the recoverability of damages by the shipper, who, in the case of road carriage, would be thus limited to the

8.33 SDR per kilogram limitation amount of the CMR, rather than to a limitation level comparable to, for example, that of the Hague-Visby Rules of 666.67 SDRs per package. In terms of this example, it was said that recovery under the per kilogram limitation of the CMR would be more favourable than under the per package limitation of a provision like that of the Hague-Visby Rules only when an individual package weighed greater than 83 kilograms which, it was said, was a rare occurrence. Finally, it was said that draft articles 89 and 90 were superfluous anyway, since if there was any conflict with another convention with respect to subject matter, in light of article 30 of the Vienna Convention of the Law on Treaties, any later convention dealing with the same subject matter would prevail over the provisions of the earlier convention.

232. While there was general agreement that draft article 90 could be deleted as potentially causing confusion with respect to the application of article 30 of the Vienna Convention on the Law of Treaties, there remained substantial support in the Working Group for the retention of draft article 89, at least for the moment. In this regard, concerns were reiterated from the earlier discussion (see para. 225 above) concerning the adequacy of draft article 27 in dealing with general conflict of conventions issues as they may arise with respect to certain unimodal transport conventions and with regard to some regional unimodal transport instruments other than the CMR, such as the uniform rules on road carriage that had been formulated by the Organization for the Harmonization of Business Law in Africa (OHADA). In particular, it was thought that draft article 89 could provide addition protection against such residual risk of conflict of conventions, to the extent that such protection was necessary in addition to the operation of draft article 27. Further, in supporting the retention of draft article 89, a specific request was made to ensure certainty regarding the intention of that provision by retaining the word “primarily” as found therein and in article 25 (5) of the Hamburg Rules.

233. It was suggested in response that such concerns regarding additional protection were unnecessary and that draft article 27 presented a clear and complete solution to the problem, and that, in fact, adding draft article 89 to the draft convention could result in confusion and could obscure the intended operation of draft article 27. In this regard, the view was also expressed that draft article 89 was too general a provision as currently drafted to fulfil the role envisioned for it of filling any potential gaps left by the application of draft article 27. However, it was suggested that in order to assuage remaining concerns regarding the clarity of the application of draft article 27 as a conflict of convention provision, the Secretariat could propose additional clarifying provisions such as those set out in paragraphs 29 and 36 of A/CN.9/WG.III/WP.78, to the effect that actions under the draft convention were available against only the contracting carrier and the maritime performing party, and that claims against other performing inland carriers were not so included. Additional suggestions were made that, in light of its role as a conflict of conventions provision, the optimal placement of draft article 27 within the draft convention might be reconsidered, and that the Secretariat could also consider clarifications to the text of the draft convention based on the Bimco COMBICONBILL referred to in paragraph 26 of A/CN.9/WG.III/WP.78.

234. Since concerns had been raised regarding a possible conflict of conventions with the Montreal Convention (see para. 225 above), it was suggested that, although the combination of air and sea transport in the same carriage was thought to be rare, additional clarification of the draft convention could be undertaken to ensure that there was no lingering conflict with the Montreal Convention. In this regard,

additional concerns were raised that a direct conflict of convention could also arise between the draft convention and the instruments under certain regional agreements affecting trade and transport, such as OHADA.

Conclusions reached by the Working Group regarding draft articles 89 and 90:

235. After discussion, the Working Group decided that:

- Draft article 89 should be deleted;
- Draft article 90 should be deleted;
- The Secretariat was requested to consider the optimal placement of draft article 27; and
- Possible drafting clarifications to ensure the proper application of the limited network system should be considered to the draft instrument in light of paragraphs 26, 29 and 36 of A/CN.9/WG.III/WP.78, and in order to ensure that there is no conflict between the draft convention and the Montreal Convention.

Draft article 64. Basis of limitation of liability *(continued from paras. 175-176 above)*

Paragraph (2) (continued)

236. The Working Group recalled that draft article 64 (2) contained two variants, both of which set out a special regime for the limitation level with respect to non-localized loss or damage of goods. It further recalled that it had agreed to defer its consideration of that paragraph until after its discussion of the relationship of the draft convention with other conventions (see paras. 175-176 above).

237. The view was expressed that, given the large number of packages that might be placed in a single container, the per package limitation in container trade might in practice lead to a higher compensation in maritime transport as compared to inland transport (see the example in para. 231 above). Therefore, a proposal was made to delete paragraph (2), since it was thought that shippers would obtain higher recovery amounts for damage under the liability regime of the draft convention, and that recovery for non-localized damage should also therefore be subject to the general liability regime under the draft convention. That proposal received some support, with some delegations suggesting that the limitation could be dealt with in draft article 27, and that, in any event, paragraph (2) introduced lack of certainty into the regime. However, it was said that it was premature to delete paragraph (2) and that the Working Group should reconsider the issue once the limitation levels in draft article 64 (1) had been determined. It was also suggested that both variants in paragraph (2) were unclear and, if either were to be retained, they would require substantial redrafting.

Conclusions reached by the Working Group regarding draft article 64 (2):

238. As this was the final issue discussed at its eighteenth session, due to a lack of time, the Working Group suspended its discussion and agreed to continue discussions on draft article 64 (2) at a future session.

General average — Chapter 18

239. The Working Group considered the text of Chapter 18 (comprising articles 87 and 88) as contained in A/CN.9/WG.III/WP.56 and recalled its earlier discussions on that chapter (see A/CN.9/510, paras. 137-143 and A/CN.9/526, paras. 183-190).

Draft article 87

240. It was recalled that draft article 87 largely reproduced the provisions regarding general average as contained in the Hague, Hague-Visby and Hamburg Rules and expressed the agreed policy that the draft convention should not affect the application of provisions in the contract of carriage or national law regarding the adjustment of general average. It was agreed that the principle contained in draft article 87 was useful and should be retained. A suggestion was made that any necessary clarification be made that the operation of article 16 (2) was not intended to have any effect on the existing general average regime.

Draft article 88

241. It was noted that paragraph (1) was intended to reflect the principle that the general average award adjustment must first be made, and the general average award established, and that liability matters would thereafter be determined on the same basis as liability for a claim brought by the cargo owner for loss of or damage to the goods.

242. It was noted that paragraph (2) dealt with the limitation period for claims in general average. It was noted that, when drafted, some doubt existed as to what the applicable time period should be, but that subsequently in 2004 the CMI had issued a revision of the York-Antwerp Rules 1994, which contained a limitation period of one year after the date of the general average adjustment or six years after the date of termination of the common maritime adventure, whichever came first. It was noted that given that it was unclear whether a limitation period in a private contract could override a limitation period in international law, and that the revised York-Antwerp Rules 2004 had not yet achieved general acceptance, it might be helpful to retain paragraph (2) for the sake of clarity, but to adjust its text to reflect the York-Antwerp Rules regarding claims “under general average bonds or guarantees”. Some support was expressed for that proposal.

243. However, opposition was expressed to the retention of article 88. It was said that incorporating the revised time limitation of the York-Antwerp Rules 2004 could create confusion given that the revised rules had not been taken up by all shipowners. It was suggested that the question of a time bar should be left to the existing legal regime for the adjustment of general average.

Conclusions reached by the Working Group regarding Chapter 18:

244. After discussion, the Working Group decided to:

- Retain article 87 in substance; and
- Delete article 88.

Jurisdiction — Chapter 16

General discussion

245. The Working Group was reminded that it had most recently considered the topic of jurisdiction at its sixteenth session (see A/CN.9/591, paras. 9-84), and that it had previously considered the topic at its fourteenth (see A/CN.9/572, paras. 110-150) and fifteenth sessions (see A/CN.9/576, paras. 110-175). It was also recalled that a revised text of the chapter on jurisdiction was prepared for the consideration of the Working Group for this session (see A/CN.9/WG.III/WP.75), which was based upon the text considered at its sixteenth session (see A/CN.9/591, para. 73), as well as consideration of that text (see A/CN.9/591, paras. 74-84). Certain suggestions by the Secretariat for drafting improvements had been included in the text in A/CN.9/WG.III/WP.75, as set out in the footnotes thereto. Discussion in the Working Group of the provisions on jurisdiction was based on the text as found in A/CN.9/WG.III/WP.75.

Proposal for reservation or clause to “opt in” to the chapter

246. It was proposed in the Working Group that, given the range of divergent views that were expressed during its sixteenth session with respect to the treatment and enforcement of choice of court clauses in the jurisdiction chapter of the draft convention, the Working Group should consider the adoption of a clause either allowing for a reservation to be taken by Contracting States to the entire chapter, or that a clause be adopted in the draft convention allowing Contracting States to specifically agree, or “opt in”, to be bound by the chapter on jurisdiction. The view was expressed that this approach would make it more likely that the draft convention would be widely accepted by Contracting States, and that a broader consensus on the chapter on jurisdiction could be reached.

247. In terms of specific drafting, it was suggested that a new provision could be drafted with a Variant A along the lines of: “Any state may make a reservation with respect to this chapter,” and a Variant B with text such as: “The provisions of this chapter will only apply to a Contracting State if that State makes a declaration to that effect.” Further, it was explained that by allowing for a reservation or an “opt in” clause to be taken to the chapter on jurisdiction, the existing provisions in paragraphs 4 and 5 of draft article 76, which allowed for Contracting States to allow choice of court agreements that met different conditions than the rest of the draft provision, could be deleted.

Partial “opt in” approach

248. The view was expressed that allowing for a reservation or “opt in” clause to the entire chapter on jurisdiction could be too extreme, and that a more flexible approach should be considered by the Working Group. It was said that certain States that might choose to become Contracting States of the draft convention might wish to retain draft article 76 in the text of the draft convention in order to give effect to choice of court clauses under conditions different from those set out elsewhere in draft article 76. It was suggested that this would be possible if the Working Group decided to include provisions allowing Contracting States to either “opt in” to the whole chapter excluding draft article 76, or to “opt in” to the entire chapter on jurisdiction, including draft article 76.

Views expressed on the two proposals

249. The Working Group proceeded to consider the two proposals as expressed above. There was strong support for allowing for a reservation or “opt in” clause to be provided for Contracting States in the draft convention with respect to the entire chapter on jurisdiction. A number of delegations that had originally expressed an interest during the sixteenth session in deleting the entire chapter on jurisdiction expressed their satisfaction with respect to this proposal and for the flexibility that it would grant to Contracting States.

250. Interest was also expressed in the partial “opt in” approach with respect to draft article 76. Delegations expressed their desire to see draft text setting out how this approach would operate prior to expressing their views on whether to adopt it or not. In particular, it was said to be important that the draft convention continue to allow for the recognition of choice of court agreements pursuant to draft article 76 (4). In considering the partial reservation or “opt in” approach, the view was expressed that care would have to be taken with respect to consequential amendments that might be necessary to ensure the appropriate operation of draft article 81 bis on recognition and enforcement. This view was echoed with respect to consequential amendments that might be required to draft article 81 bis if the Working Group adopted the approach of providing for a reservation or “opt in” clause with respect to the entire chapter on jurisdiction, as well.

Reservation versus “opt in” approach

251. While no strong view was expressed in favour of or against the reservation or the “opt in” approach, it was suggested that the “opt in” approach might be easier for Contracting States to adopt, as it simply allowed States passively to allow the relevant provisions to remain inoperable rather than to take the positive act of making a reservation with respect to those provisions. The general view in the Working Group was that delegations preferred to review draft text outlining the complete and partial reservation and “opt in” approaches prior to expressing definitive views on those proposed approaches.

Conclusions reached by the Working Group regarding the whole and partial reservation or “opt in” approaches:

252. After discussion, the Working Group decided that:

- There was support in the Working Group for the inclusion in the draft convention of a reservation or an “opt in” clause for the whole of chapter 16;
- Interest was expressed in the reservation or partial “opt in” approach proposed with respect to draft article 76 and the recognition of choice of court agreements pursuant to draft article 76 (4); and
- Draft text setting out in more detail the various approaches proposed should be prepared for the consideration of the Working Group, along with any necessary text on consequential adjustments to other provisions, such as draft article 81 bis.

Discussion of specific provisions in chapter 16

253. The Working Group proceeded to examine the provisions in the chapter on jurisdiction with a view to considering whether a decision could be reached

regarding any alternative text presented in A/CN.9/WG.III/WP.75, and whether resolution could be reached regarding other questions raised.

Draft article 75. Actions against the carrier

254. Several delegations expressed the view that the opening phrase of draft article 75, “unless the contract of carriage contains an exclusive choice of court agreement that is valid under articles 76 or 81” should be deleted as allowing for too much freedom of contract in terms of establishing which places should be considered appropriate for the establishment of jurisdiction. In addition, questions were raised regarding whether there should be a provision in the draft convention establishing the rules for designating the appropriate jurisdiction for actions against the shipper and the consignee, in addition to those provisions in draft article 75 and 77, providing such rules for actions against the carrier and the maritime performing party, respectively. In regard to both issues, a preference was expressed for the approach taken in article 21 of the Hamburg Rules. In response, it was said that while there was some sympathy for these suggestions, it was thought that, in light of the delicate compromise struck on these issues during its sixteenth session, the Working Group should at the moment retain its views, as expressed in the text under consideration, and that concerns about the freedom of contract were perhaps best left to the consideration of draft article 76 on choice of court agreements. In response to a concern raised regarding the use of the word “plaintiff” in draft article 75 and that it could allow an opening for carriers seeking to circumvent the provision by seeking a declaration of non-liability in an anti-suit injunction, it was explained that that problem might be best dealt with in terms of possible drafting adjustments to draft article 80 (2), which was aimed primarily at that problem.

Draft article 76. Choice of court agreements

255. Despite a view expressed to the contrary, there was general agreement in the Working Group to delete the square brackets surrounding the phrase “claims against the carrier” and retain the text therein, and to delete the alternative “[disputes]” in draft article 76 (1).

256. With regard to the alternative text set out in square brackets in draft article 76 (2) (b), there was general agreement to retain the text “designates the courts of one Contracting State or one or more specific courts of one Contracting State” as allowing parties to be more precise in choosing the court in a choice of court agreement. It was further agreed to add the word “clearly” at the beginning of the chosen phrase, and to delete the alternative text set out in square brackets in the draft provision.

257. It was agreed that draft paragraph 76 (2) (c) could be deleted, since sufficient protection was thought to have been provided as between the parties to a volume agreement in draft paragraph 76 (2) (a).

258. It was proposed that the text in draft paragraph 76 (3) (b) be retained without square brackets. However, it was suggested that since the term “transport document” had a very broad meaning under the draft convention, the provision should be narrowed slightly to provide for proper notice to be provided to the third party to the volume contract, by deleting the phrase “issued in relation to” and substituting the phrase, “that evidences the contract of carriage for”. There was general support for that proposal.

259. With regard to draft article 76 (3) (d) regarding the requirement for binding a third party to a volume contract to a choice of court agreement concluded therein, a concern was expressed that the conditions set out in the provision were not sufficiently clear with respect to how such parties would be bound. In response to this concern, it was proposed that subparagraph (d) be amended to refer to the law of the agreed place of destination of the goods, rather than to the “rules of private international law of the court seized”. While this suggestion was welcomed as a possible solution, concerns were expressed regarding what law was being chosen under this formulation, and it was suggested that “the place of receipt of the goods” might be better wording, but that that connecting factor was unusual, and it was thought to be preferable to refer to the law of the forum or the law governing the contract. Further, the view was expressed that the draft convention had avoided elsewhere making specific reference to the law chosen, and that the current text as found in A/CN.9/WG.III/WP.75 might be preferable. Support was expressed for the view that the provision should be left as it was currently found, or failing that, that the law of the forum should be used so as to avoid a potentially uncertain and confusing rule like the “law of the place of receipt of the goods”. It was agreed that alternative text could be proposed for draft article 76 (3) (d) as follows: “[the law of the place of destination of the goods][the law of the place of receipt of the goods] [the applicable law pursuant to the rules of private international law of the law of the forum]”, and that the Secretariat should have regard to the use of the word “court” in this draft article, and specifically, to proper usage of the term “competent court”.

260. The Working Group agreed that under the proposal to include a reservation or “opt in” clause regarding the entire chapter on jurisdiction, paragraphs 4 and 5 of draft article 76 would be deleted.

Draft article 77. Actions against the maritime performing party

261. After discussion, the Working Group agreed that the text in square brackets in draft article 77 (b) should be retained as necessary to further define the maritime performing party and the brackets around them deleted, but that the words “single” and “all of” could be deleted as redundant.

Draft article 79. Arrest and provisional or protective measures

262. Although the view was expressed that retaining the text in square brackets in draft article 79 might effectively provide an extra ground of jurisdiction under the draft convention by including the place of arrest, the Working Group agreed to retain the text in square brackets and to delete the brackets.

Draft article 80. Consolidation and removal of actions

263. With respect to the square brackets appearing in draft article 80 (2), there was support for the proposal that, of the texts presented, the best text was the following compromise between the three alternative texts: “seeking a declaration of non-liability or any other action that would deprive a person of its right to select the forum under articles 75 or 77.” Two other issues mentioned for consideration by the Secretariat in future drafting were the possibility that the reference in draft article 80 to articles 76 or 81 might need to be adjusted if the option with respect to the partial “opt in” approach was taken, and that with respect to draft article 80 (2), the Secretariat could consider clarifying that the cargo claimant must designate a

forum to which the action must be removed, or there would be no removal. The Working Group approved both suggestions.

Draft article 81. Agreement after dispute has arisen and jurisdiction when the defendant has entered an appearance

264. There was approval for the suggestion to add the word “competent” before the word “court” in draft article 81 (2).

Draft article 81 bis. Recognition and enforcement

265. The Working Group reiterated its view that the text of draft articles 81 bis (2) and (3) might need to be adjusted depending on what decision was made regarding the whole or partial reservation or “opt in” with respect to chapter 16. It was submitted that draft article 81 bis did not place an obligation on Contracting States to recognize and enforce judgments from other States but offered the possibility to do so subject to their national laws. The submission was accepted by the Working Group. Further, the Secretariat was requested to review the use of the terms “may” and “shall” in draft article 81 bis (1).

Conclusions reached by the Working Group regarding the provisions in chapter 16:

266. After discussion, the Working Group decided that:

- The Secretariat should make the adjustments to the provisions of chapter 16 as approved above in paragraphs 245 to 265.

Arbitration — Chapter 17

267. The Working Group was reminded that it had most recently considered the topic of arbitration at its sixteenth session (see A/CN.9/591, paras. 85-103), and that it had previously considered the topic at its fourteenth (see A/CN.9/572, paras. 151-157) and fifteenth sessions (see A/CN.9/576, paras. 176-179).

268. The Working Group was reminded that, following the consideration of the topic of arbitration during its sixteenth session, a revised text for a new chapter on arbitration had been proposed (see A/CN.9/591, para. 95). Discussion on that proposal ensued in the Working Group at that same session, and it was decided that the general approach taken in those provisions was acceptable and should be retained for future consideration by the Working Group (see A/CN.9/591, paras. 96 to 103). It was further recalled that draft article 83 of that revised text provided for a claimant to commence either arbitral proceedings according to the terms of the arbitration agreement in the contract of carriage, or to institute court proceedings in any place, provided that such place was specified by draft article 75 of the draft convention. It was further recalled that the purpose of that approach was to ensure that, with respect to the liner trade, the right of the cargo claimant to choose the place of jurisdiction for a claim pursuant to draft article 75 was not circumvented by way of enforcement of an arbitration clause. In addition, the Working Group was reminded that it had attempted in that approach to limit interference with the right to arbitrate in the liner trade while protecting the cargo claimant, but that the intended approach in the non-liner trade was to allow for complete freedom to arbitrate, thus preserving the status quo in both trades.

269. At that time, it was noted that the approach of that revised text in paragraph 95 of A/CN.9/591, would in practice mean that an otherwise valid arbitration agreement might not be considered binding if the claimant chose to institute court proceedings elsewhere. This particular aspect of that revised text was felt to be possibly inconsistent with article II of the Convention on the Recognition and Enforcement of Foreign Arbitral Awards, 1958 (the New York Convention), which generally recognized the binding nature of arbitration agreements and mandated courts to decline jurisdiction in respect of disputes which the parties had agreed to submit to arbitration. Therefore, it was suggested that the Working Group should seek the opinion of UNCITRAL Working Group II (Arbitration) on the provisions of the draft convention relating to arbitration (see A/CN.9/591, para. 101).

270. The Working Group was informed that the Secretariat had since facilitated consultations between experts that participated in the activities of both Working Groups with a view to devising ways to implement the approach taken by Working Group III at its sixteenth session in a manner that did not conflict with the New York Convention and the policies advocated by UNCITRAL in the field of arbitration. As a result of those consultations, the following text was proposed for consideration by the Working Group:

“CHAPTER 17. ARBITRATION

“Article 83. Arbitration agreements

“1. Subject to this chapter, parties may agree that any dispute that may arise relating to the carriage of goods under this Convention shall be referred to arbitration.

“2. The arbitration proceedings shall, at the option of the person asserting a claim against the carrier, take place at one of the following locations:

“(a) Any place designated for that purpose in the arbitration agreement; or

“(b) Any other place situated in a State where any of the places specified in article 75, paragraph (a), (b) or (c), is located.

“3. The designation of the place of arbitration in the agreement is binding for disputes between the parties to the agreement if it is contained in a volume contract that clearly states the names and addresses of the parties and either

“(a) is individually negotiated; or

“(b) contains a prominent statement that there is an arbitration agreement and specifies the location within the volume contract of that agreement.

“4. When an arbitration agreement has been concluded in accordance with paragraph 3 of this article, a person that is not a party to the volume contract is bound by the designation of the place of arbitration in that agreement only if:

“(a) The place of arbitration designated in the agreement is situated in one of the places referred to in article 75, paragraphs (a), (b) or (c);

“[(b) The agreement is contained in the contract particulars of a transport document or electronic transport record that evidences the contract of carriage for the goods in respect of which the claim arises;]

“(c) The person to be bound is given timely and adequate notice of the place of arbitration; and

“(d) Applicable law [for the arbitration agreement] permits that person to be bound by the arbitration agreement.

“5. The provisions of paragraphs 1, 2, 3, and 4 of this article are deemed to be part of every arbitration clause or agreement, and any term of such clause or agreement to the extent that it is inconsistent therewith is null and void.

“Article 84. Arbitration agreement in non-liner transportation

“1. If this Convention has been incorporated by reference into a charter party or other contract of carriage that is excluded from the application of this Convention pursuant to article 9, then the incorporation does not include this chapter unless it explicitly expresses the intent to incorporate this chapter.

“2. Nothing in this Convention affects the enforceability of an arbitration agreement in a charter party or other contract of carriage that is excluded from the application of this Convention pursuant to article 9 if that agreement has been incorporated by reference into a transport document or electronic transport record issued under that charter party or other contract of carriage and the provision in the transport document or electronic transport record that incorporates the agreement (i) identifies the parties to and date of the charter party; and (ii) specifically refers to the arbitration clause.

“Article 85. Agreements for arbitration after the dispute has arisen

“Notwithstanding the provisions of this chapter and chapter 16, after a dispute has arisen, the parties to the dispute may agree to resolve it by arbitration in any place.

“Article 85 bis. Application of Chapter 17

“Variant A

“The provisions of this chapter will apply only to a Contracting State if that State makes a declaration to this effect in accordance with Article XX [which will describe the formalities of the declaration process].

“Variant B

“A Contracting State may make a reservation in accordance with Article XX [which will describe the formalities of the reservation process] with respect to this chapter.”

271. It was explained that under the above text the arbitration agreement itself would be considered to be binding, and the cargo claimant would not be allowed to disregard the arbitration agreement by filing suit at court. Instead, the text used the approach taken in article 22 of the Hamburg Rules to provide a mechanism to

protect the cargo claimant from being denied its right to choose the place of jurisdiction by way of enforcement of an arbitration clause. Under the above text, the claimant was given the option to either commence arbitral proceedings according to the terms of the arbitration agreement in the contract of carriage, or in any place specified by draft article 75 of the draft convention. It was noted that in the past the Working Group had been reluctant to follow the approach taken in the Hamburg Rules, mainly because of concerns that moving arbitration proceedings away from the place of arbitration originally agreed might in practice render arbitration impracticable, in particular where the arbitration rules of the arbitral institution chosen by the parties did not accommodate the conduct of arbitration proceedings away from the arbitral institution's seat. It was observed, however, that in view of the objections that had been raised to the text tentatively agreed at the Working Group's sixteenth session, reverting to the approach taken in article 22 of the Hamburg Rules, with the adjustments contained in the text proposed in paragraph 270 above would, in balance, offer a better alternative for achieving the Working Group's policy objective of protecting the interests of the cargo claimant in a manner that respected the general principle of the binding nature of arbitration agreements. Problems that might arise from a request by the claimant that arbitration proceedings take place at a place other than the agreed place of arbitration would be solved within the framework of the New York Convention and in the light of the case law that had interpreted its text.

272. By way of further explanation of the text proposed in paragraph 270 above, it was said that an attempt was made to align that text as closely as possible with the approach taken in the chapter of the draft convention on jurisdiction. In particular, it was noted that draft article 83 (3) was intended to be the counterpart of draft article 76 with respect to volume contracts, and that draft article 83 (4) was intended to parallel the approach of draft article 76 with respect to the binding effect of arbitration agreements on third parties to the contract of carriage. Further, Variants A and B of draft article 85 bis reflected the proposed reservation or "opt in" approaches to the chapter on arbitration that were also suggested with respect to the chapter on jurisdiction, and it was said that should the Working Group adopt the partial "opt in" approach to the chapter on jurisdiction, corresponding changes would be necessary with respect to this provision as well, since whatever choice the Working Group made with respect to the particular mechanism according to which chapter 16 would apply should also extend to chapter 17.

General discussion

273. Although some delegations reiterated their opposition to including any provisions in the draft convention on arbitration, it was pointed out that the reservation or "opt in" approach set out in draft article 85 bis should alleviate those concerns. While there was agreement in the Working Group that further reflection would be necessary on the revised text in paragraph 270 above, support was expressed for the compromise approach and the principles expressed therein to allow for as broad an approach to arbitration as possible in the liner trade, while at the same time ensuring that the rules establishing jurisdiction in claims against the carrier in draft article 75 were not circumvented. Support was again expressed for the principle that there should be broad ability to resort to arbitration in the non-liner trade. Certain specific observations were made as follows with respect to the specific text of the chapter under consideration.

Draft article 83

274. The proposal was made to delete the phrase “against the carrier” in the chapeau of paragraph 2, since it was thought to be more in keeping with the nature of arbitration if a claim could be asserted by either party to the dispute. Support was expressed for this proposal. In response to a question regarding the operation of the word “binding” in the chapeau of draft article 83 (3) and its intended operation with draft article 83 (2), it was confirmed that the use of that term in that context was intended to completely prohibit “exclusive” arbitration agreements in the liner trade. It was proposed that in the case where the carrier took the initiative to have recourse to arbitration at the place designated by the draft convention, the other party could nonetheless determine that the proceedings would take place at one of the places specified in draft article 75 (a), (b) or (c).

275. Concern was also expressed with respect to draft article 83 (4) regarding the conditions under which third parties to arbitration agreements in contracts of carriage would be bound. It was thought that subparagraph (d) was problematic, in that it provided that one of the conditions for a third party to be bound by the arbitration agreement was that the “applicable law” permitted that party to be so bound. In particular, it was thought that the phrase “applicable law” was too vague, in that it did not specify whether it was the procedural law or the law chosen by the arbitration itself, and that a more precise term should be used, such as the law of the contract of carriage, or the law of the arbitration proceedings, or the law of the State in which the arbitration proceedings took place. It was noted that a similar discussion had taken place in the Working Group regarding the law applicable to binding a third party in the case of choice of court provisions in a volume contract in draft article 76 (3) (d) (see para. 259 above), and doubt was expressed whether a decision could be reached in respect of this similar provision in the arbitration chapter, since it was thought to be more controversial than the provision in the jurisdiction chapter. The Working Group was therefore encouraged to refrain from making any specific reference about the applicable law in this regard. It was also stated that a third party should be bound by an arbitration clause only if it had agreed to it.

Draft article 84

276. It was observed that draft article 84 differed substantially from the version previously considered at the sixteenth session of the Working Group (see A/CN.9/591, para. 95). It was explained that draft article 84 was intended to preserve traditional resort to arbitration in charter parties in the non-liner trade, but to ensure the inclusion in that category of those situations where the draft convention was incorporated by reference. It was noted that paragraph 2 of draft article 84 had been redrafted from the previous version, but that the intention had been to keep the provision substantially the same, except for slightly limiting the circumstances under which a bill of lading issued pursuant to a charter party could contain an arbitration clause. In particular, the revised approach was attempting to deal with a particular problem by allowing bills of lading issued pursuant to a charter party to incorporate the charter party’s arbitration clause.

277. While the intended operation of this provision was thought to be helpful, there was support for the suggestion that paragraph 1 of draft article 84 should be deleted, as it was seen as a material rule that could affect the interpretation of such incorporation by reference, and could be used as a mechanism to affect charter parties, which were, in any event, intended to be outside of the scope of

the draft convention. Further it was suggested that the phrase “or jurisdiction” should be added after the phrase “enforceability of an arbitration” in order to cover the limited number of cases where charter parties incorporated litigation rather than arbitration, and that the phrase “parties to and date of” should be deleted from subparagraph 2 (i). As a result of concerns that paragraph 2 set out conditions that could have the unwanted effect of establishing conditions that restricted the use of arbitration clauses in the non-liner trade, it was suggested that the text following the second instance of the phrase “or other contract of carriage” should be deleted.

Draft article 85 bis

278. It was noted that draft article 85 bis setting out the reservation and “opt in” alternatives for the application of the chapter on arbitration was not linked to similar provisions in chapter 16 on jurisdiction, since every State would have complete freedom to decide on the application of chapter 17, but that the choice on whether or not to adopt chapter 16 would be made by some States in a joint fashion.

Conclusions reached by the Working Group regarding chapter 17 on arbitration:

279. After discussion, the Working Group decided that:

- The draft text set out in paragraph 270 above represented a good compromise and acceptable grounds on which to continue discussions toward final drafting;
- Delegations would still have the right to comment further on the text pending further consideration of the new version presented during the session; and
- Although some suggested drafting changes did not receive sufficient support, such as the deletion of the phrase “against the carrier” in draft article 83 (2), the Secretariat should prepare a revised version of the text, taking into account the above discussion and making any necessary drafting adjustments, particularly in light of any adjustment necessary with respect to a partial “opt in” approach.

III. Other business

Planning of future work

280. The Working Group agreed to complete consideration of any outstanding issues from its second reading, including freedom of contract, and to commence its third reading of the draft convention, at its nineteenth session (New York, 16 to 27 April, 2007). The Working Group also took note that its twentieth session was scheduled for 15 to 25 October 2007, subject to the approval of the Commission at its fortieth session in 2007.

281. The Working Group expressed its strong satisfaction with the continued progress made on the draft convention, particularly in light of the heavy agenda at its current session. The Working Group agreed that it was on target to complete its third and final reading of the draft convention at the end of 2007.

**B. Note by the Secretariat on the preparation of a draft convention on
the carriage of goods [wholly or partly] [by sea] — Limitation of Carrier Liability,
submitted to the Working Group on Transport Law
at its eighteenth session
(A/CN.9/WG.III/WP.72) [Original: English]**

In preparation for the eighteenth session of Working Group III (Transport Law), the Government of China submitted to the Secretariat the document attached hereto as an annex with respect to the limitation of the carrier's liability in the draft convention on the carriage of goods [wholly or partly] [by sea]. The Government of China advised that the text was intended to facilitate consideration of the topic of the limitation of the carrier's liability for breaches of its obligations under the draft convention in the Working Group by compiling the views and comments of various delegations into a single document for discussion by the Working Group.

The document in the attached annex is reproduced in the form in which it was received by the Secretariat.

ANNEX

I. Introduction

1. The 10th session of Working Group III (Transport Law), held between 16 and 20 September 2002 in Vienna, started an initial discussion on the issue of limitation of the carrier's liability (see A/CN.9/525, paragraphs 65 to 70 and 81 to 92). The 13th Session of Working Group III (Transport Law), held between 3 and 14 May 2004 in New York, held the second round of discussions on the issue of limitation of the carrier's liability (see A/CN.9/552, paragraphs 38 to 51 (basis for the limitation of liability), 25 to 31 (liability for loss caused by delay), and 51 to 62 (loss of the right to limit liability)). Following that discussion, the Working Group asked the secretariat of the United Nations Commission on International Trade Law (UNCITRAL) to draft a plan for revising the articles that had been considered. The draft text of the articles on the limitation of liability was contained in paragraphs 3 and 6 to 8 of A/CN.9/WG.III/WP.39. The secretariat compiled and submitted in November 2005 a new, amalgamated text of the draft convention, and issued it as A/CN.9/WG.III/WP.56. The provisions of the limitation of liability in A/CN.9/WG.III/WP.56 are to a certain extent different from A/CN.9/WG.III/WP.39 in terms of their overall structure. A/CN.9/WG.III/WP.56 has an independent Chapter 13 on the limitation of liability, including draft article 64: basis of limitation of liability (corresponding to draft art. 18 of A/CN.9/WG.III/WP.39), draft article 65: liability for loss caused by delay (corresponding to draft art. 16 (2) of A/CN.9/WG.III/WP.39), draft article 66: loss of the right to limit liability (corresponding to draft art. 19 of A/CN.9/WG.III/WP.39) and draft article 104: amendment of limitation amounts (corresponding to draft art. 18 (bis) of A/CN.9/WG.III/WP.39). The present document is based on the text of the draft convention in A/CN.9/WG.III/WP.56.

2. In November 2005, the Chinese Delegation distributed to all interested delegations an informal questionnaire on the issue of limitation of the liability of the

carrier's liability. The purpose of this document is to facilitate the discussion by the Working Group on this topic. Five delegations submitted their responses to the questionnaire. The text of the present document does not necessarily reflect the views of the Chinese Delegation, but represents a compromise that may be reached, which the Working Group may wish to consider.

II. The Core Provisions of Chapter 13

3. The core provision of Chapter 13 of the draft convention is draft article 64: Basis of limitation of liability.
4. Paragraph 1 of draft article 64 provides for the limitation level of liability. It adopted a per package and per kilogram limitation approach, and treated as exceptions goods with a declared value and those regarding which other agreements exist between the parties.
5. Paragraph 2 of draft article 64, which includes two variants, of which Variant A is intended as a clarification of the text of Variant B, without change in substance. Thus, differences exist in the text, but the issues covered remain the same. Both variants regulate the limitation of liability when it cannot be determined during which leg of the transport the loss or damage occurred.
6. Paragraph 3 of draft article 64 regulates the limitation of liability in terms of the number of packages or shipping units when using containers, pallets or other similar means of transport.
7. Paragraph 4 of draft article 64 provides for the unit of account, and requires that the Special Drawing Rights (SDR) defined by the International Monetary Fund be used as the unit of account.
8. There are two alternative texts set out in draft article 65, Liability for loss caused by delay. Variant A is again intended as a clarification of the text of Variant B, without a change in substance.
9. The final provision in Chapter 13 is draft article 66, Loss of the right to limit Liability.
10. Paragraph 1 of draft article 66 provides for circumstances under which the right to limit liability for loss of or damage to goods, and for breaches of the carrier's obligations under the draft convention may be lost.
11. Paragraph 2 of draft article 66 provides for circumstances under which the right to limit liability for loss caused by delay in delivery may be lost.
12. The final provision of relevance to this report is draft article 104, Amendment of limitation amounts.
13. Draft article 104 was drafted by the Secretariat at the request of the Working Group, by drawing on such international conventions as the 2002 Protocol to the Athens Convention and the United Nations Convention for Liability of Operators of Transport Terminals in International Trade.

III. Draft article 64: Basis of Limitation of Liability

Paragraph 1: Breaches of the carrier's obligations under the draft convention

14. At the 13th session of the Working Group, some delegates suggested adding “in connection with the goods” of Article 4(5) of the Hague Rules to enable this paragraph to be applicable to circumstances including misdelivery or misrepresentation of the goods in the bill of lading. The conclusion of the discussion on this issue was to insert “in connection with the goods” in brackets into this and other paragraphs for the Working Group to review and discuss in future (see paragraphs 41 to 44 of A/CN.9/552). A/CN.9/WG.III/WP.56 replaces the wording of the whole phrase “loss of, damage to [or in connection with goods] with “breaches of its obligations under this Convention”. In the responses to the informal questionnaire, some delegations were opposed to using “breaches of its obligations under this Convention”, suggesting that this was an expansion of the limitation on liability enjoyed by the carrier. Other delegations that responded to the informal questionnaire, however, suggested that the Working Group should first discuss what other liabilities of the carrier than those included in chapters 6 and 7 should be subject to limitation. For example, it seems to be possible for a carrier to limit liability in cases of misdelivery of the goods, delivery without presentation of negotiable transport document or misrepresentation in the transport document. It seems impossible to cover the above cases by simply using “loss of or damage to goods”. As a result, it may not be justifiable to hold that the carrier is not entitled to limit its liability since there might be no question of “intent” or “knowledge” when the carrier acted as mentioned above. Therefore, the correct approach may be to use suitable wording to include the cases mentioned above in the liability limitation covered by draft article 64. Whether or not the carrier should lose the liability limit should be decided by judging in accordance with draft article 66 if the acts of the carrier were taken “with intent” or “with knowledge”.

15. On the basis of the above discussion, it seems that the Working Group may wish to consider:

- (1) What other liabilities of the carrier than those included in Chapters 6 and 7 should be subject to limitation? Should misdelivery of the goods, delivery without presentation of negotiable transport document or misrepresentation in the transport document be covered by the limitation of liability covered by draft article 64?
- (2) If the Working Group decides that the limitation of liability should cover the circumstances mentioned above, then which specific wording can accurately reflect the intention of the Working Group, i.e. “loss of or damage to goods or [or in connection with the goods]” or “[breaches of its obligations under this Convention]”?

Paragraph 1: Limitation level of liability

16. At the 13th session of the Working Group, delegates expressed the belief that it was not yet the time to discuss the level of the limitation of liability, and therefore did not discuss the level of limitation of liability that the convention should adopt (see para. 39 of A/CN.9/552). Following the 13th session, the Secretariat compiled at the request of the Working Group in December 2005 a comparative table on limitation levels of carrier liability (A/CN.9/WG.III/WP.53) on the basis of the initial information provided by a number of States. In the responses to the informal

questionnaire, some delegations suggested adopting the level of limitation of liability of the Hague-Visby Rules, while other delegations suggested adopting the level of limitation of liability of the Hamburg Rules. Still another delegation suggested greatly raising the level of limitation of liability, arguing that the 1996 Protocol to amend the Convention on Limitation of Liability for Maritime Claims had greatly increased the limit set by the 1976 Convention.

17. If the draft convention adopted the limitation of liability of the Hague-Visby Rules, i.e. 666.67 SDR per package or 2 SDR per kilogram, it would be the same as the limitation of liability currently applied by the majority of countries, which would help the adoption of the draft convention as it would have less impact on the existing system. However, considering the fact that any revision to the draft convention would increase appropriately the limitation of liability on the basis of considering price factors such as inflation, it seemed feasible to raise it to 835 SDR per package or 2.5 SDR per kilogram as required by the Hamburg Rules. Since the draft convention would be an international transport convention rooted mainly in maritime transport, the appropriate approach seemed to be an investigation into the average value of goods shipped through maritime transport and into claims for cargo loss or damage, and then to determine a scientific level of limit of liability on the basis of the result of the investigation. Some States that responded to the informal questionnaire carried out work similar to this, and the conclusion was that the average value of goods and the absolute majority of the claims were under the level of limitation of liability of 2 SDR or 2.5 SDR per kilogram. As shown by the restricted investigation that China has conducted into judicial decisions, the absolute majority of the claims were under the level of limitation of liability of 2 SDR per kilogram.

18. On the basis of the above discussion, the Working Group may wish to consider:

What level of limitation of liability should the draft convention set after considering factors such as the average value of goods and claims against goods loss or damage?

Paragraph 2: Non-localized loss or damage

19. The Working Group discussed paragraph 2 of draft article 64 in detail at its 12th session, the result of which was an even split between the opinions which favoured maintaining the provision, and those which favoured eliminating it (see paragraphs 43 to 50 of A/CN.9/544). The Working Group reiterated this opinion but did not discuss it in detail at its 13th session (see paragraph 45 of A/CN.9/552). In the responses to the informal questionnaire, one delegation favoured maintaining this provision, but the majority of the delegations who responded recommended eliminating it, arguing that the draft convention was an international convention that would be in fact mainly targeted on maritime transport plus other legs of transport. Since the draft convention focuses on maritime transport, it was suggested that it would be not appropriate to include this paragraph in the draft convention. Furthermore, limitation of liability was not an isolated issue, but instead was closely related to such issues as the basis of liability and the conditions for the loss of the limitation of liability. It was suggested that it was not advisable to introduce the limitation of liability for individual legs of transport.

20. The Working Group may also wish to note that article 19 of the United Nations Convention on International Multimodal Transport of Goods provides that where the

leg of the multimodal transport in which the loss or damage occurs is determined, the higher limit of liability provided either by an international convention or a domestic law that governs that leg of the transport should be applied. This is in keeping with the principle in draft article 27 of the draft convention. Nevertheless, the United Nations Convention on International Multimodal Transport of Goods does not include any provision for non-localized loss or damage. It seems that the unified limit of liability provided for in article 18 of that Convention should be applied. It seems that the draft convention should adopt a similar approach to apply the limit of liability of draft article 64, paragraph 1, to non-localized loss or damage.

21. The two alternative texts on this provision do not have any substantive difference. Variant A further clarifies Variant B.

22. On the basis of the above discussion, the Working Group may wish to consider:

After thorough consideration of the advantages and disadvantages of providing for non-localized loss or damage, should this provision be deleted so as to apply the limit of liability of draft article 64, paragraph 1, to non-localized loss or damage?

IV. Draft article 65: Liability for loss caused by delay

Economic Loss

23. Draft article 65 includes two variants. Variant A is intended to clarify the content of Variant B. In the responses to the informal questionnaire, one delegation expressed support for Variant A, believing that it was clearer. There were also delegations who supported Variant B, but they suggested replacing “consequential loss” with “economic loss”. Still another delegation proposed distinguishing different kinds of loss, suggesting that the Working Group should make clear that the decrease in the market value was a kind of economic loss, and therefore should be subjected to a limitation of liability such as [one times] the freight.

24. On the basis of the above discussion, it seems that the Working Group may wish to consider:

Which of Variants A or B is clearer? If Variant B is chosen, the Working Group may wish to consider replacing “consequential loss” with “economic loss” so as to cover the loss represented by the decrease in market value.

Limitation Level for Economic Loss Caused by Delay

25. On the issue of what level should be set for the limitation of liability for economic loss caused by delay in delivery, most delegations that responded to the informal questionnaire proposed to apply the liability limit of 2.5 times the freight payable on the goods delayed, as required by the Hamburg Rules, and supported the rule that the total amount of compensation received in accordance with this article and draft article 64, paragraph 1, should not exceed the liability limit for the total loss of the goods calculated according to draft article 64, paragraph 1. However, another delegation that responded believed that one times the freight would be enough. It was proposed that the specific issue of the level of the limitation for loss caused by delay should be settled on the basis of further investigation, for which

consideration should be made of many factors, including the future recognition and acceptability of the amount chosen.

26. On the basis of the above discussion, it seems that the Working Group may wish to consider:

Should the liability limit of the economic loss caused by delay in delivery be set at 1 or 2.5 times of the freight?

Unless otherwise agreed

27. As for the wording “unless otherwise agreed”, some delegations that responded to the informal questionnaire proposed that the limit of liability of this article should be compulsory, and not subject to negotiation. Another delegation believed that the limit of liability in this article, although compulsory, could be negotiated, but that the limit could only be increased rather than decreased, according to the spirit of the principle of freedom of contract in chapter 20. Still another delegation believed that it was not necessary to include “unless otherwise agreed” because a correct conclusion could be drawn by following the spirit of the principle established in draft article 94 of Chapter 20. It was suggested that it would be superfluous to insert “unless otherwise provided” into this article.

28. On the basis of the above discussion, it seems that the Working Group may wish to consider:

Is it necessary to keep the wording “unless provided otherwise”?

V. Draft article 66: Loss of the right to limit liability

29. Draft article 66 provides the conditions for the loss by the carrier of the right to limit its liability. The original paragraph was divided into two paragraphs, regulating respectively the circumstances of the loss of the right to limit liability related to loss of or damage to goods, and that related to loss caused by delay in delivery. In addition, the wording of “breach of the carrier’s obligation under this Convention” was inserted into paragraph 1 in lieu of the phrase “[or in connection with] the goods”, as it was in paragraph 1 of draft article 64. In the responses to the informal questionnaire, there seemed to be no substantial difference of views among the delegations regarding this provision. The delegations that responded broadly supported a separate paragraph 2 to deal with the issue of delay in delivery, and it appears that they were also satisfied with the conditions for losing the limitation of liability.

30. Only one delegation expressed misgivings about the fact that “breach of the carrier’s obligation under this Convention” was added to the first part of paragraph 1 of this draft article, yet it was not mentioned in the latter part. It was suggested that the inconsistency between the wording of the first part and the latter part of the paragraph could cause problems. The example was given that, in the case of misrepresentation of the transport document, the carrier did not cause the loss of or damage to goods with intent, or recklessly and with knowledge that loss or damage would probably result, yet it was obvious that the carrier should lose the right to limit its liability in such circumstances.

31. On the basis of the above discussion, it seems that the Working Group may wish to consider:

Would the insertion of “breach of the carrier’s obligation under this Convention” into paragraph 1 result in inconsistency between the wording in the first part and the latter part of this paragraph, which might cause problems for the application of this paragraph?

VI. Draft article 104: Amendment of limitation amounts

Paragraph 1

32. In the responses to the informal questionnaire, some delegations proposed the addition of a rule on an amendment procedure for the revision of the liability limit for loss caused by delay. However, another delegation that responded was opposed to it, arguing that freight itself was a variable factor.

33. On the basis of the above discussion, it seems that the Working Group may wish to consider:

Whether amendment of the limit of liability for loss caused by delay of Article 65 should be added to paragraph 1?

Paragraph 2

34. In the responses to the informal questionnaire, some delegations mentioned that the number of States that could apply for amendment of the limitation of liability, i.e. one-quarter or one-half of the total, was related to the number of ratifying States required for the Convention to come into force. If the latter number was high, then a quarter would be enough. If the latter number was low, then half would seem to be more acceptable. In addition, it was suggested that a second condition could be considered, i.e. to set the minimum number of States required for an application to amend the limitation of liability.

35. On the basis of the above discussion, it seems that the Working Group may wish to consider:

What is the appropriate number of States that could apply for amendment of the limitation of liability that should be required in paragraph 2? Should a second condition should be added, i.e. to set the minimum number of States required to apply for amendment of the limitation of liability?

C. Note by the Secretariat on the preparation of a draft convention on the carriage of goods [wholly or partly] [by sea] — Comments and proposals by the International Chamber of Shipping, BIMCO and the International Group of P&I Clubs on topics on the agenda for the 18th session, submitted to the Working Group on Transport Law at its eighteenth session
(A/CN.9/WG.III/WP.73) [Original: English]

In preparation for the eighteenth session of Working Group III (Transport Law), the International Chamber of Shipping, BIMCO and the International Group of P&I Clubs submitted to the Secretariat the document attached hereto as an annex containing their comments and proposals on provisions of the draft convention on the carriage of goods [wholly or partly] [by sea] scheduled for discussion during the session.

The document in the attached annex is reproduced in the form in which it was received by the Secretariat.

ANNEX

Draft convention on the carriage of goods [wholly or partly] [by sea] (A/CN.9/WG.III/WP.56)

International Chamber of Shipping, BIMCO and the International Group of P&I Clubs

Comments and proposals on the topics scheduled for discussion at the 18th session of UNCITRAL Working Group III, to be held in Vienna, 6-17 November 2006

1. In order to assist the deliberations of the Working Group at its next session, the International Chamber of Shipping, BIMCO and the International Group of P&I Clubs offer the following comments on the following topics scheduled for discussion:

- A. Jurisdiction and Arbitration (Chapters 16 and 17)
- B. Transport Documents and Electronic Records (Chapter 9)
- C. Delay and outstanding matters regarding shippers' obligations (Chapters 6 and 8)
- D. Limitation of Liability (Chapters 13 and 21)
- E. Rights of and Time for Suit (Chapters 14 and 15)

A. Jurisdiction and Arbitration (Chapters 16 and 17)

2. The draft convention should not introduce prescriptive provisions for dispute resolution. The absence of provisions in the Hague and Hague-Visby Rules has not detracted from their wide-spread application or created difficulties of principle or practice. In contrast, the inclusion of provisions in the Hamburg Rules has militated against their use. There are, therefore, strong arguments for leaving commercial

parties to determine dispute resolution arrangements most suited to their particular needs. In this context, it is perhaps worth reiterating a point made and acknowledged by many participants in the Working Group, namely that contracts for the carriage of goods are essentially a matter of private rather than public law, which in the modern era are in virtually all cases made between parties of similar bargaining strength who are almost invariably insured.

Jurisdiction

3. The proposals put forward at the sixteenth session of the Working Group in Vienna in 2005, while less constricting than provisions in the Hamburg Rules, nevertheless intrude on party freedom and create legal uncertainty.

Draft article 75 — Actions against the carrier

4. It should be clarified that this draft article does not apply where draft articles 83 and 84 come into play.

Draft article 76 — Choice of court agreements

5. Exclusive jurisdiction clauses are widely used in contracts of carriage. Such clauses create uniformity and legal certainty (two of the main purposes for developing international conventions) for both cargo interests and carriers. Draft article 76 as presently drafted will, other than in the case of volume contracts, result in a lack of uniformity and certainty and promote forum shopping by claimants. Moreover, the inclusion of both paragraph 4, which permits a state to recognize jurisdiction clauses that do not otherwise satisfy the requirements of draft article 76, and paragraph 5, which despite paragraph 4, permits a claimant to proceed in those jurisdictions specified in draft article 75, will inevitably lead to conflicts between competing jurisdictions and necessarily additional litigation with all its associated cost and delays.

Draft article 80 — Consolidation and removal of actions

6. The position is further complicated where an action is brought against both the contracting carrier and maritime performing party. If an exclusive jurisdiction clause cannot be enforced, the contracting carrier might be required to defend the case in a jurisdiction to which he has not agreed in the contract of carriage and this would be unreasonable.

Concursus of Claims

7. The absence of concursus provisions in the event of multiple claims is a significant shortcoming where exclusive jurisdiction clauses are not accepted. As drafted, a shipowner would be forced to defend actions in an almost unlimited number of jurisdictions in the case of claims relating to multi-modal cargoes arising out of the same incident. It would be unreasonable to expect the carrier to defend such suits in many different jurisdictions, possibly subject to varying limitation regimes. Costs would be increased considerably, to the detriment of all parties, and the settlement of claims delayed where the carrier was entitled to limit liability under a global limitation regime. This issue needs to be reconsidered.

Draft article 79 — Provisional or protective measures

8. The provision opens the way for the forum of arrest of a ship (*forum arresti*) to be an additional, and unpredictable, jurisdiction open to manipulation by claimants seeking to avoid compliance with the fora listed in draft article 75. In earlier discussions, the Working Group has largely been of the view, no doubt due to the uncertainty which would be created, that *forum arresti* should not provide an additional connecting factor. This issue needs to be addressed through a conflict of conventions provision which gives preference to the jurisdiction provisions of the draft convention over the provisions on jurisdiction/*forum arresti* of the 1952 and 1999 Arrest Conventions to the extent that this is possible under international law.

Arbitration

9. What has been said above in relation to the benefits of giving effect to choice of jurisdiction clauses is equally applicable to arbitration agreements. Arbitration has long been used by parties to a maritime adventure as a means of resolving disputes speedily and economically. This has resulted in the development of a number of arbitration centres of experience and expertise supported by a well developed legal framework. In industry's view, the introduction of provisions in the draft convention that would curtail the freedom of the parties to a contract of carriage to choose a particular place of arbitration would be both restrictive and unnecessary and would again promote uncertainty. It has been argued that an unrestricted right to include arbitration arrangements could be used by shipowners to circumvent jurisdiction provisions giving rise to the proposals considered by the Working Group at its 16th session (see A/CN.9/591, paras. 90 to 103) to limit the extent of such freedom. Nevertheless, no such difficulties have been experienced under the present system and it can be expected that carriers who have generally preferred to use jurisdiction, particularly in the context of non-bulk trades, would continue with this practice. However, alternative arrangements might at some future stage be a preferred mutual option and should not be rendered unworkable by the draft convention.

Draft article 83

10. Under this provision, arbitration agreements, other than those falling within the draft convention's definition of non-liner (i.e. tramp) transportation, would be subject to the default provisions under this rule whereby a claimant has the ability to opt for judicial proceedings despite the existence of an arbitration agreement. However, the dividing line between the trade types is not necessarily clear and vessels using "liner terms" but not operating to a regular schedule or those undertaking one-off, occasional voyages or engaged in the carriage of specialized cargoes appear to be subject to the regime. The precise meaning of the provision is unclear and likely to be open to differing interpretations.

11. The position in liner trades operating on defined routes and at scheduled times is protected by the proposals relating to liner service volume contracts (see draft article 95 of the draft convention). This will enable regular shippers to agree with carriers to derogate from the provisions of the draft convention, including specific arrangements for dispute resolution matters which might, in the parties' choice, be by reference to the courts or arbitration. Use of the system of liner service volume contracts can be expected to increase.

12. In contrast, the same flexibility to agree binding and enforceable arbitration provisions will be problematic in trades outside the scope of draft article 84.

Draft article 84 — Arbitration agreement in non-liner transportation

13. This broadly reflects practice in tramp trades where arbitration is the preferred method for dispute resolution. It will be necessary to ensure that third party interests are equally bound to an agreement but this is primarily a matter of drafting.

14. However, there is an outstanding issue. The original wording in the chapeau made reference to “[a jurisdiction or] an arbitration agreement” but the text in square brackets was removed, without explanation, in the final draft. Although, for the most part, charter parties incorporate arbitration agreements, litigation is used in a limited number of cases. The deletion of the phrase could, therefore, have implications for the exclusivity of such arrangements. In order to preserve the position the following amendment is suggested:

“Article 84 Dispute resolution agreements in non-liner transportation

Nothing in this Convention affects the enforceability of an arbitration or jurisdiction agreement in a contract of carriage [remainder of article unchanged]”

B. Transport Documents and Electronic Records (Chapter 9)

Draft article 37 — Issuance of the transport document or the electronic transport record

15. It is essential that the draft convention contains unambiguous provisions as to who is entitled to receive the transport document. We believe the shipper should be the person entitled to receive the transport document, however, this should only be the declaratory rule, which means that the shipper may request that the carrier hands over the transport document to somebody else, e.g. the consignor/seller. It is for the seller in a FOB sales contract to ensure in the sales contract that the FOB buyer/shipper agrees with the carrier that the transport document should be issued to the seller or the consignor.

Draft article 38 — Contract particulars

16. Provisions requiring name and address of the shipper should be included.

Draft article 40 — Deficiencies in the contract particulars

17. Draft article 40 (3) should be deleted. We are opposed to the notion that where the transport document or electronic record is ambiguous or silent as to the identity of the carrier, there is a presumption that the registered owner of the ship is the carrier. A registered owner may be a financial institution not involved with the operation or trading of the ship. Furthermore, the presumption is inappropriate in an instrument which covers door-to-door transport, where the unidentified carrier might well be a non-vessel operator (NVO). Likewise, the possibility of a bareboat charterer being presumed to be the carrier also strikes us as inappropriate and inequitable given that ships will often be under management contracts, where the registered owner and any bareboat charterer have little to do with the day to day operations.

18. Channelling of liability is a feature of international pollution liability and compensation conventions where the claimant is an unconnected third party, but is inappropriate for parties involved in the contractual carriage of goods. A shipper should ascertain the identity of the contracting carrier, and parties acquiring bills of lading should not be placed in a better position than the shipper who, in accordance with draft article 38 (1) (e), will be aware of the name and address of the carrier set out in the transport document or electronic transport record. During informal consultation, a majority of delegates addressing the issue opposed draft article 40 (3).

Draft article 41 — Qualifying the description of the goods in the contract particulars

19. Apart from the more technical comments made below, draft article 41 (a) and (c) are acceptable. However, draft article 41 (b) is difficult to read, unclear and repetitious. The heading of draft article 41 governs (a) as well as (b), and it seems then very unclear why the latter part of (b) largely repeats what already follows from the heading of draft article 41. The problem may be solved by simply deleting the latter part of (b), i.e. all the words from “the carrier may include ...”.

20. The words in draft article 41 (a) (i): “the carrier can show that it” seem to contradict the burden of proof rule in draft article 42 (c) where it is for the party claiming that the carrier did not act in good faith to prove this.

21. In an effort to overcome these problems, we suggest the following revised text for draft article 41:

“Article 41. Qualifying the description and weight of the goods in the contract particulars

The carrier, if acting in good faith when issuing a transport document or an electronic transport record, may qualify the information referred to in article 38 (1) (a), 38 (1) (b) or 38 (1) (c) in order to indicate that the carrier does not assume responsibility for the accuracy of the information furnished by the shipper:

(a) For non-containerized goods

(i) if the carrier had no reasonable means of checking the information furnished by the shipper, it may so state in the contract particulars, indicating the information to which it refers, or

(ii) if the carrier reasonably considers the information furnished by the shipper to be inaccurate, it may include a qualifying clause stating what it reasonably considers accurate information.

(b) For containerized goods

(i) unless the carrier [or a performing party] in fact inspects the goods inside the container or otherwise has actual knowledge of the contents of the container before issuing the transport document or the electronic transport record, provided, however, that in such case the carrier may include a qualifying clause if it reasonably considers the information furnished by the shipper regarding the contents of the container to be inaccurate.

(ii) *the carrier may qualify any statement of the weight of goods or the weight of a container and its contents with an explicit statement that the carrier has not weighed the container if*

1. *the carrier can show that neither the carrier nor a performing party weighed the container, and the shipper and carrier did not agree prior to the shipment that the container would be weighed and the weight would be included in the contract particulars, or*
2. *the carrier can show that there was no reasonable means of checking the weight of the container.”*

Draft article 43 — Prima facie and conclusive evidence

22. It is inappropriate that non-negotiable documents should provide conclusive evidence because conclusive evidence should only attach to negotiable documents where a third party buyer of goods relies on the terms of the negotiable document when acquiring the goods. Accordingly, Variants A and B should both be deleted.

Draft article 44 — Evidentiary effect of qualifying clauses

23. The suggestion in footnote 154 to attach legal importance to whether a container is delivered intact and undamaged will give rise to a lot of uncertainty and disputes. Furthermore the alternative seems to mix up documentary liability and cargo liability. Thus for these reasons the alternative text in footnote 154 is not acceptable.

C. Delay and outstanding matters regarding shippers' obligations (Chapters 6 and 8)

24. During the 17th session of the Working Group the question of liability for delay for the shipper was extensively discussed and a number of options were considered (see A/CN.9/594, paras. 199 to 207). No solution was achieved, but there was considerable support for the principles of having a balanced solution, i.e. either the draft convention should provide that the carrier as well as the shipper should be liable for delay, or that neither of them should be liable under the Convention.

25. Carriers remain very much opposed to liability for delay outside of any express agreement between the parties, apart from liability for physical loss of/or damage to the goods or to the vessel caused by delay. Accordingly, we fully support the proposals in A/CN.9/WG.III/WP.69.

26. If A/CN.9/WG.III/WP.69 does not achieve sufficient support, and it is decided to leave the question of liability for delay to national law, it is essential in order to provide certainty and predictability that the draft convention establishes some restrictions as to what delay liabilities shippers and carriers may incur under national laws and a distinction may have to be made between bulk and liner trades. Accordingly the draft convention should contain the following elements:

1. Where physical damage to the goods or the vessel takes place following delay, the draft convention should provide for carrier and shipper liability and limitation of liability, as set forth in 3 below;
2. The draft convention should give a right for States to provide for a combination of carrier and shipper liability for delay as follows:

- i. The liability of the carrier should be limited to loss of market value of the goods and similar losses directly connected with the goods following delay. The liability and limits of liability should be as set forth in 3 below;
 - ii. The liability of the shipper should be for loss directly related to delaying the vessel in its loading, departure, voyage, arrival or unloading. The liability and limits of liability should be as set forth in 3 below.
3. The shippers' and carriers' liability for delay under the draft convention or under national laws should for the shipper be an ordinary fault-based liability limited to e.g. the value of the goods. The carriers' liability should follow the general liability rules of the draft convention and be limited to the freight (i.e. to an amount equivalent to one times the freight payable on the goods delayed).
27. If it is decided to regulate liability for delay in the draft convention and not leave it to national law, the rules of the draft convention should be based upon the same principles as suggested above, e.g. provide for a restricted liability for delay for the shipper and the carrier and provide for limitation of liability for both parties.

Dangerous goods

28. At the 17th session of the Working Group it was decided to considerably limit the scope of shipper obligations to provide information under draft article 30 (b) by adopting the proposal in A/CN.9/WG.III/WP.69 (para. 6) (see A/CN.9/594, paras. 190 to 194). In view of this change, it seems justified to provide for strict liability for the shipper for providing correct information. The reference in both Variant A and Variant B of paragraph 2 of draft article 31 to draft article 30 (b) and (c) should be maintained, and the proposal in paragraph 25 of A/CN.9/WG.III/WP.67 should not be followed.

D. Limitation of Liability (Chapters 13 and 21)

Draft article 64 — Basis of limitation of liability

29. We firmly believe that it would be appropriate to include the Hague-Visby limits in draft article 64 (1) of the draft convention. Claims' experience demonstrates that the overwhelming majority of claims fall within current liability levels (see footnote 2 of A/CN.9/WG.III/WP.34). Moreover, the adoption of the Hague-Visby limits would in itself constitute a significant increase in the world-wide average limits in use. We suggest that the following amendment should be made to draft article 64:

*“Subject to articles 65 and 66, paragraph 1, the carrier’s liability for breaches of its obligations under this Convention is limited to 666.67 SDR per package or other shipping unit or 2 SDR per kilogram of the gross weight of the goods lost or damaged, whichever is the higher, **except where ad valorem freight is agreed and paid** or the nature and the value of the goods have been declared by the shipper before shipment and included in the contract particulars [or when a higher amount than the amount of limitation of liability set out in this article has been agreed upon between the carrier and the shipper].”*

30. Whether or not the words in the last parenthesis should be included depends on the outcome of the discussion under draft article 94.

31. It is of great importance that all liabilities following breaches of the carrier's duties, obligations etc. under the draft convention are subject to limitation. We suppose that the words in draft article 64 "*for breaches of its obligations under this Convention*" are aiming exactly at this. Thus wrongful delivery and misrepresentation constitute breaches of obligations under the draft convention for which the carrier may be liable, but also entitled to limitation of liability (unless, of course, in the case of intentional breach).

32. A right to limit liability for delay under national law has to be included in the draft convention. We refer to our comments above in relation to delay.

33. We are very much opposed to draft article 64 (2) both in Variant A and in Variant B, and support its deletion. Any contract of carriage falling under the draft convention must include a maritime leg, and in by far most transports falling under the draft convention, the maritime leg will be the most important leg time-wise and length-wise. Under these circumstances, it would be quite logical to apply the liability and limitation rules of the maritime leg for concealed damages. There are of course a number of cases where the maritime leg is insignificant, e.g. a transport from the northern part of Sweden via ferry over the Sound to the southern part of Italy. We believe that in practically all such cases it will be possible to establish whether the damage took place during the ferry crossing or at some stage during the road transport. We question whether the proposals in both Variant A and in Variant B will really benefit claimants if, as the evidence suggests, the overall majority of claims are within the Hague-Visby limits. We also fear that increased liability for concealed damages may deter maritime carriers from offering multimodal transport documents and lead to increased insurance costs. Where larger claims are involved, carriers will do their utmost to establish where the damage took place in order to secure a recourse claim against the sub-carrier. The underlying reason for Variant A and Variant B — that a large number of claims are claims for concealed damages — is highly questionable. For this reason alone, Variant A and Variant B should not be supported. Furthermore, the proposals would lead to great uncertainty. This is especially so, if the reference to national law is retained.

Draft article 104 — Amendment of limitation amounts

34. We question the appropriateness of a tacit amendment procedure in a private law instrument. However, if Hague-Visby limits are agreed, a tacit amendment procedure would not be opposed. In that case, we would support the principles in A/CN.9/WG.III/WP.34 (Section II).

35. Draft article 104 (5) is modelled on the Athens Convention, and the factors contained in the provision are appropriate for a public law instrument primarily concerned with regulating claims for loss of life and personal injury to passengers. However, the draft convention is primarily concerned with property claims of commercial parties. In addition to the list of factors in article 104 (5), we consider that account should be taken of average cargo values and freight rates when acting on a proposal to amend the limits.

36. While we would not object to changes in monetary values being taken into account, we would point out that many other factors are involved, such as the type and value of commodities, the fall in real terms of the cost of many consumer goods, and improvements in packaging and transport generally. Furthermore,

preliminary research suggests a significant decline in the relative value of freight rates over the years.

E. Rights of and Time for Suit (Chapters 14 and 15)

Chapter 14 — Rights of suit

37. We very much doubt the need to include this chapter in the draft convention. It should be deleted. The right to sue is normally regulated by general rules in most legal systems and to establish a special set of rules applicable in this connection, which may differ from the rules applicable under national law, might be difficult, if not impossible.

Chapter 15 — Time for Suit

Draft article 69 — Limitation of actions

38. We support retention of the present one year prescription period as set forth in Variant A of draft article 69. With modern speedy communication etc., it is difficult to understand that there should be a need to extend this period. The tendency in national law today is to shorten prescription periods. We would suggest that Variant A of draft article 69 is extended to cover actions against maritime performing parties as well, but would suggest further that it is confined to actions against contracting carriers and maritime performing parties. We suggest this in view of the fact that the draft convention does not provide for rules as to jurisdiction etc., vis-à-vis shippers. Accordingly, instituting proceedings against shippers may be a somewhat more complicated task justifying a longer prescription period, and it may be better to leave the question to national law.

Draft article 72 — Action for indemnity

39. We prefer Variant B of draft article 72 (b).

Draft article 74 — Actions against the bareboat charterer

40. We refer to our comments above in relation to draft article 40.

**D. Note by the Secretariat on the preparation of a draft convention on the carriage of goods [wholly or partly] [by sea] — Shipper's liability for delay: Document presented for the information of the Working Group by the Government of Sweden, submitted to the Working Group on Transport Law at its eighteenth session
(A/CN.9/WG.III/WP.74) [Original: English]**

In preparation for the eighteenth session of Working Group III (Transport Law), the Government of Sweden submitted to the Secretariat the document attached hereto as an annex with respect to shipper's liability for delay in the draft convention on the carriage of goods [wholly or partly] [by sea]. The Swedish delegation advised that, following the consideration of the topic of the shipper's liability for delay by the Working Group during its seventeenth session (see A/CN.9/594, paras. 199 to 207), the document was intended to facilitate consideration of the topic in the Working Group at its eighteenth session.

The document in the attached annex is reproduced in the form in which it was received by the Secretariat.

ANNEX

Shipper's Liability for Delay in the Draft Convention on Carriage of Goods by Sea — A Study of the Risks and Consequences

I. Introduction

1. During the seventeenth session of Working Group III on transport law in New York from 3 to 13 April 2006, the question whether the draft convention should include provisions on the shipper's liability for delay was discussed (see A/CN.9/594, paras. 199 to 207). A number of delegations asked for a study of the risks and consequences of having such a liability for delay included in the draft convention. The Government of Sweden has agreed to prepare such a study.

2. In part II of this study, the regulation of the liability of the shipper for delay in the Hague-Visby and Hamburg Rules is presented. Parts III and IV contain an account of the regulation in the draft convention of the liability for delay of the carrier and the shipper, respectively. It has proved to be necessary to take into account also the carrier's liability for delay, since its inclusion in the draft convention to a certain extent affects the actual liability of the shipper. In parts V and VI, some possible risk scenarios regarding liability for delay are outlined and analysed. Part VII contains a study on the insurability of liability for delay on the part of both the carrier and the shipper. Finally, in part VIII, different options regarding the regulation of liability for delay are presented and analysed.

II. Hague-Visby and Hamburg Rules

3. The Hague-Visby rules do not include any provisions on the liability of the carrier for delay. Consequently, a carrier can only be liable for delay if national law imposes such a liability on the carrier, or if the carrier in the contract of carriage has agreed to deliver the goods at a certain time. The Hamburg Rules include liability of the carrier for delay based on fault in article 5. The liability is limited to two and a half times the freight payable for the goods delayed (article 6 (1)(b)).

4. Pursuant to the Hague-Visby and Hamburg Rules, the shipper may be liable for loss, including loss as a result of delay, which the shipper causes through its fault (see article 4 (3) of the Hague Rules and article 12 of the Hamburg Rules). In addition, the shipper is strictly liable for loss as a result of inaccurate information furnished by him (see article 3 (5) of the Hague Rules and article 17 (1) of the Hamburg Rules). Such loss may include delay. According to article 13 (2)(a) of the Hamburg Rules, the shipper is also under the obligation to inform the carrier about dangerous goods and to mark and label them accordingly. The shipper is strictly liable for loss, damage or delay as a result of a breach of its obligation to so inform the carrier. Further, the liability of the shipper under these provisions is unlimited.

III. Carrier's liability for delay in the draft convention

5. Delay in delivery is defined in draft article 22 of the draft convention. According to this provision, delay in delivery occurs "when the goods are not delivered at the place of destination provided for in the contract of carriage within the time expressly agreed upon or, in absence of such an agreement, within the time it would be reasonable to expect of a diligent carrier, having regard to the terms of the contract, the characteristics of the transport, and the circumstances of the voyage or journey". This means that if the parties to the transport agreement have expressly agreed that the goods shall be delivered at a certain time, the carrier will be strictly liable for this obligation. (It is assumed here that it will be possible for the carrier to take on a stricter liability than that provided for in the draft convention, as referred to in draft article 94.) In all other cases, the carrier will be liable for delay caused by its fault. According to draft article 17 (1), the shipper would have to establish a *prima facie* breach by the carrier, i.e. that the goods were not delivered within a reasonable time and that loss occurred because of the delay. In cases where the carrier cannot be said to have guaranteed the time of delivery, the carrier could, according to paragraphs (2) and (3) of draft article 17, defeat the claim by establishing that the particular circumstances of the individual voyage justified the longer length of the voyage.

6. The compensation payable if goods are delayed is regulated in draft article 65. The draft convention as set out in A/CN.9/WG.III/WP.56 included two variants, however, the essence of both is, that the liability for consequential loss arising out of the delay is limited to one times the freight payable on the goods delayed. The compensation for physical loss or damage to the goods arising out of delay is calculated according to the general rule on liability for loss or damage to the goods. This means that according to draft article 23, the compensation will be calculated by reference to the value of the goods at the place and time of delivery. In addition, the carrier will have the right to limit the compensation to a certain amount per package or per kilogram of the gross weight of the goods lost or damaged.

7. If the delay causes physical loss or damage to the goods as well as consequential loss, such as loss of production, the shipper or the consignee will have the possibility to claim compensation for all loss, subject to the limitation provisions in draft articles 64 and 65. However, in a situation where the total loss exceeds the limit that is to be established in draft article 64, the shipper or the consignee will not be able to claim additional compensation for consequential loss equal to one times the freight. In case of a total loss, the limitation level in draft article 64 will instead form an absolute limitation level.

8. In addition to the liability for delay in draft article 17, the carrier will, according to the network principle in draft article 27, be liable for delay in relation to the shipper according to other mandatory transport conventions. A typical example here could be that the goods are transported by road under the Convention on the Contract for the International Carriage of Goods by Road, 1956, as amended by the 1978 Protocol (the CMR convention) or by rail under the Uniform Rules concerning the Contract for International Carriage of Goods by Rail, Appendix to the Convention concerning International Carriage by Rail, as amended by the Protocol of Modification of 1999 (the COTIF/CIM rules) from the port of discharge in Rotterdam to Berlin in Germany. If the delay occurs during this transport leg, the carrier will be liable for delay limited to one times the freight according to the CMR convention or to four times the freight according to the COTIF/CIM rules.

IV. Shipper's liability for delay in the draft convention

9. According to draft article 28 and draft article 30, the shipper is under the obligation to deliver the goods ready for carriage and to provide the carrier with certain information, instructions and documents. The liability for delay, due to breach of these obligations, is regulated in draft article 31. During the sixteenth session of Working Group III, it was decided that the liability for breach of these obligations should be based on fault with an ordinary burden of proof (see para. 138 of A/CN.9/591). Only in cases where dangerous cargo is transported would the shipper be strictly liable for delay due to failure to inform the carrier of the dangerous nature of the goods or for the failure to mark or label such goods accordingly (see draft article 33). In addition to this, it was decided that the shipper would be strictly liable for loss or damage due to the fact that information and instructions actually provided to the carrier were inaccurate (see paras. 148 to 150 of A/CN.9/591).

10. The liability of the shipper in the present draft text of the convention is an unlimited one. This means that the shipper, once it is found liable, may have to pay compensation for any direct as well as indirect loss that the carrier suffers. The compensation will only be limited by general principles on causation in national law.

V. Effects of the current draft regulation of the carrier's liability for delay — possible risk scenarios

11. With regard to the carrier liability for delay, there are four scenarios that could possibly occur. The first one is that the ship is delayed for some totally external reason of a force majeure character listed in draft article 17 (3), for example a storm, a war, etc. Here, there is no causation between the action of the carrier and

the loss that the shipper suffers and consequently, the carrier is not liable in this situation.

12. The second scenario is that the delay is caused by the carrier. Here, the question whether the carrier is liable will depend on whether the carrier can be said to have guaranteed the time of delivery or if the delay occurred as a result of the fault of the carrier. Standard practice today seems to be that carriers never guarantee that the goods are delivered at a certain time, i.e. carriers never take on a strict liability for delay. Normally, it is explicitly stated in the transport documents currently used on the market that the time of delivery is to be considered an estimated one. The reason for this is that there is often no need for an exact time. Shippers tend to use sea transport where there are larger volumes of goods of a relatively low value. Goods of a higher value, such as specially manufactured electronic equipment, where the date of delivery is often much more important, are usually transported by air. In order to find out whether the carrier was at fault in a situation where there is no explicit agreement on the time of delivery, a court would have to compare the normal time for a journey like the one agreed on and the actual time that the journey lasted. Here, it is important to note that, like the time of delivery indicated in a transport document, the information in the timetables is not to be considered as exact. In addition to this, the court would have to take into account the characteristics of the transport and other circumstances of the individual journey. This would mean that where the master on board decides to reduce the speed because of heavy weather or where there is traffic congestion in a harbour, the carrier will not be liable for any resulting delay.

13. A third scenario is that the delay is caused by the shipper, for example, that the shipper has not provided the documents required for customs clearance. It is explicitly regulated in draft article 17 (3)(h) that in a situation like this, the carrier is relieved from liability for any delay in relation to the shipper.

14. A fourth scenario is that the delivery is delayed because of the act or omission of another shipper. An example of this could be where shipper A claims compensation from the carrier because of the fact that the discharge of the vessel was delayed in the port of destination. According to draft article 17 (1), the carrier will, in this situation, be relieved from liability if it can prove that the delay was not due to the fault of the carrier, but to the fact that shipper B did not submit the documents required. Shipper B cannot, in this situation, be considered as a servant or contractor for whom the carrier is responsible.

15. The conclusion here is that the carrier's risk exposure regarding liability for delay is rather limited. This is also underlined by the fact that even if the vessel is delayed, this does not mean that the delivery of all cargo will automatically be delayed. For example, if the vessel arrives in the harbour two days late, but a part of the cargo was supposed to be stored in a terminal for four days waiting for transport by truck to the final inland destination, despite the delay of the vessel, the carrier will be able to deliver on time at the final destination. On the other hand, in certain situations the risk of late delivery at the final destination will increase because of the fact that goods will have to be stored while in transit due to delay during one of the previous legs of the transport. Also, the liability for delay imposed on the carrier as a result of the network principle in draft article 27 will, in practice, be rather limited, because of the fact that such liability will most often only concern a few containers, since the ship's cargo will be spread on different trucks and trains after the discharge of the container ship.

16. In addition to the fact that the risk of being liable for delay is rather limited, the carrier also has the right to limit the compensation to, at present, one times the freight payable on the goods delayed. This means that, in a worst case scenario regarding a voyage from Gothenburg to New York, where a vessel with 7,000 containers on board is detained and all of the cargo is delayed, the carrier will have to pay compensation of US\$ 20,650,000 in total, based on the fact that the freight rate for the carriage of a 20 ft. container is US\$ 2,950. Further, if there is a total loss, the loss due to delay will be regarded as part of the physical loss of the goods, which means that the shipper will not be able to claim any compensation separate from the compensation for the physical loss. In other words, the limitation level for physical loss will here form an absolute limitation level.

VI. Effects of the current draft regulation of the shipper's liability for delay — possible risk scenarios

17. Regarding the shipper's liability for delay, there are two possible risk scenarios which ought to be considered. The first one is that the shipper is not able to deliver the cargo ready for carriage in the port of loading. In the liner trade, this would result in the vessel sailing without having taken on board the containers belonging to that specific shipper. In the bulk trade, the shipper might be subject to liability for demurrage, etc., but this is something which is outside the scope of the draft convention.

18. The second scenario is that goods already taken on board a vessel give rise to delay of the vessel. If the delay depends on the fact that the shipper failed to inform the carrier about the dangerous character of the goods or failed to mark or label them accordingly, the shipper will be strictly liable for the resulting delay. The shipper will also be strictly liable for delay due to incorrect information and documents actually submitted to the carrier. In all other cases, the shipper will be liable only in the case where the shipper is at fault. A typical example here would be if it were found that containers belonging to one shipper were infected with insects and the whole vessel was ordered not to enter the port of discharge before the cargo had been fumigated. Another example would be if the customs authorities refused to let the vessel discharge her cargo because of the fact that there were documents missing regarding the goods in some containers. The carrier may here suffer a direct loss, such as costs for fumigation, costs for returning to a previous port for the discharge of certain containers, inspections on board, etc. However, these are risks that shippers are already facing today. It also seems that the direct loss of a carrier in such a situation will in most cases be rather limited.

19. The great risk here consists of the fact that the consequential losses that other cargo owners may suffer as a result of this may be enormous. But this is not something that will increase the risk exposure of the carrier. As noted above, the latter is not responsible for the acts and omissions of a shipper and consequently not liable in relation to other shippers for the loss they suffer because of those acts or omissions. Therefore, the risk of a recourse action by the carrier against the shipper is minimal here. Only in a situation where the delay has been caused by the carrier and the shipper jointly and the former has paid full compensation to the other shippers would there seem to be room for a recourse action. However, in practice, such a situation will not occur because of the provision on apportionment in draft article 17 (4). Instead the real risk seems to be of the shipper being sued by the other

shippers in tort. But this is a risk that a shipper will always be faced with regardless of the liability rule in chapter 8 of the draft convention.

VII. Insurance coverage

20. It can be assumed that liability for delay on the carrier's side will be insurable by the protection and indemnity (P&I) clubs. The risk that the carrier will become liable for economic loss as a result of delay at all appears to be rather small and the risk that a worst case scenario would occur appears to be even smaller. This is illustrated by the fact that the national provisions on liability of the carrier for delay in the Scandinavian Maritime Code of 1994 have so far not given rise to any case law. And if a worst case scenario would occur, the compensation would be limited to a certain amount. The additional risk for including liability for delay under the P&I insurance can therefore be assumed to affect insurance premiums only marginally.

21. Regarding insurance coverage of the risk of the shipper becoming liable to the carrier for delay, the picture is more complicated. Normally, general cargo insurance will not include any liability risks. This is the case with, for example, the Institute Cargo Clauses. On certain markets, like the Scandinavian market, for example, cargo insurance may cover minor liability risks. For example, if a cargo hold becomes contaminated in connection with the damage of the cargo, a shipper may be able to recover from the insurer some indemnification for costs for the cleaning of cargo holds. Pure economic loss will never be covered.

22. It is also uncertain whether such risks are covered by the general liability insurance of a company that acts as a shipper. As indicated above, the shipper will here be exposed to the direct loss the carrier will suffer, and in some cases also to the indirect loss, i.e. loss that other shippers suffer. However, it is important to note that in relation to the regulation proposed in the draft convention, these are not new risks. They already exist today. For example, a shipper that causes damage to the ship will also be exposed to the risk of having to indemnify the carrier not only for the physical damages to the vessel, but also for pure economic loss, such as loss of freight, etc. In addition the shipper will run the risk of being sued by other shippers for costs they have suffered because of the delay.

VIII. Alternative solutions to the problem and their effects

23. From a practical point of view there seem to be three possible options regarding the regulation of the liability for delay in the draft convention. One option is to leave the liability for delay completely outside the scope of the draft convention, except for the liability for delay as a result of the submission of inaccurate information (cf. article 3 (5) of the Hague Rules). In other words, all references to delay would be deleted. Regarding the carrier's liability for delay, this would in practice mean that the question would be left to national law, and there would be no uniformity. To leave out the regulation of the carrier's liability for delay would also create a discrepancy between, on the one hand, the draft convention, and on the other hand, the CMR convention and the COTIF/CIM rules, according to which the carrier has mandatory liability for delay. Because of the network principle adopted in draft article 27, the carrier will be exposed to such liability. Another consequence of not having liability for delay for the contracting carrier included in the draft convention would probably be that performing land

carriers would be more exposed to claims regarding delay because of the fact that they often operate under national mandatory liability regimes, which include liability for delay.

24. It could also be argued that already today, door-to-door concepts form important parts of modern production systems and that a key element of such a concept is that the goods are delivered in time. In order to reduce costs, the production of components is often out-sourced at the same time, as warehousing is kept at a minimum in the logistics chain. Deleting liability for delay would, in other words, to a certain extent undermine the idea that the draft convention should consist of modern legislation for the global shipping and logistics industry.

25. Regarding the shipper's liability for delay, a decision to delete all references to delay would not lead to the result that the shipper would have no liability for delay at all according to the draft convention. Despite the fact that there would be no specific reference to delay in draft article 31, the shipper would still under many jurisdictions be liable for delay as a consequence of the fact that the vessel was damaged or that documents were not submitted.

26. A question that might arise here, regardless of the fact whether or not a reference to delay is included in draft article 31, is whether the liability of the shipper ought to be limited and if so, what the limitation level ought to be. One advantage of having a limitation is that the risk exposure would otherwise be severe if the vessel were totally lost. The shipper would then be liable for direct loss (the vessel and other equipment) as well as for indirect loss (freight, etc.).

27. A second option would be to keep carrier liability for delay in the draft convention, but to delete the specific references to delay in the chapter on shipper's obligations. This would leave the carrier with uniform limited liability. As indicated above, this would not affect the shipper because of the fact that the carrier is not liable for the acts of a shipper in relation to other shippers. The advantage of such a solution is that while the delivery of the goods at the destination is a key obligation in the transport agreement, the same thing cannot be said about the obligations of the shipper to deliver the goods and certain documents to the carrier. The primary obligation of the shipper is to pay the freight. Consequently, the same need to create uniformity on the international level does not seem to exist regarding liability for delay on the shipper side as compared to liability for delay on the carrier side. As indicated above, the effect of such a deletion will not be that the shipper will not be liable for delay at all. The shipper will still be liable for delay that occurs as a result of damage to the ship or as a result of the submission of inaccurate information at the same time as the liability for other delay will be left to national law.

28. A third option would be to retain all references to delay on the part of the carrier as well as on the part of the shipper. In that situation, there might be a need for the inclusion of a limitation level regarding the shipper's liability that is acceptable for both the carrier and the shipper. It is not an easy task to establish such a level because of the fact that the type and amount of damage may vary substantially between different cases. One way of doing this would be to hold the shipper fully liable for physical loss, such as loss and damage to the ship and other equipment. Regarding other economic loss, direct or indirect, the shipper would be liable for loss equal to the value of the goods shipped. This is not a perfect solution because of the fact that cargo of rather low value may cause as much damage as more valuable cargo, but at least it will create a situation where shippers who are shipping large volumes of more valuable cargo will have to take on greater liability.

An advantage with linking the limitation level to the value of the goods shipped instead of linking it to the weight of the goods is that the establishment of an SDR-formula could be avoided. A system based on the value of the goods would be reminiscent of the solutions often found in commercial sales contracts where the maximum damage payable is linked to the contract sum, i.e. the value of the goods sold. The limitation level regarding delay in delivery could be, for example, 15 or 30 per cent of the contract sum. However, because of the fact that shippers may sometimes ship rather small volumes, the limitation level here should be equal to the full value of the goods rather than a part of the value. A limitation level would promote predictability and would make it possible to create better insurance coverage on the part of the shipper, for example by adding a liability element to the existing cargo insurance or company liability insurance.

E. Note by the Secretariat on the preparation of a draft convention on the carriage of goods [wholly or partly] [by sea] — Chapter 16: Jurisdiction, submitted to the Working Group on Transport Law at its eighteenth session

(A/CN.9/WG.III/WP.75) [Original: English]

In preparation for the eighteenth session of Working Group III (Transport Law), the Secretariat has prepared a revised text of chapter 16 on jurisdiction of the draft convention on the carriage of goods [wholly or partly] [by sea] for the consideration of the Working Group which, along with a definition from chapter 1, is attached in the annex to this note. The revised text is based upon the text accepted by the Working Group during its sixteenth session (see A/CN.9/591, para. 84) as set out in paragraph 73 of A/CN.9/591, with drafting clarifications proposed by the Secretariat as indicated following the consideration of the text by the Working Group (see A/CN.9/591, paras. 74 to 84).

ANNEX

CHAPTER 1. GENERAL PROVISIONS

Article 1. Definitions

29 bis. “Competent court” means a court in a Contracting State that, according to the rules on the internal allocation of jurisdiction among the courts of that State, may exercise jurisdiction over a matter.¹

CHAPTER 16. JURISDICTION

Article 75. Actions against the carrier²

Unless the contract of carriage contains an exclusive choice of court agreement that is valid under articles 76 or 81, the plaintiff has the right to institute judicial proceedings under this Convention against the carrier in a competent court within the jurisdiction of which is situated one of the following places:

- (a) The domicile of the carrier;³
- (b) The contractual place of receipt or the contractual place of delivery;

¹ As agreed by the Working Group in paragraph 73 of A/CN.9/591. The phrasing is the same as that used in article 5 (3)(b) of the Convention on Choice of Court Agreements, 2005.

² Text as set out in paragraph 73 of A/CN.9/591, and accepted in substance by the Working Group in paragraph 84 of A/CN.9/591, with a reference to article 81 added to correct the text.

³ Reference corrected to “carrier” rather than to “defendant” in order to be consistent with draft article 77 regarding actions against maritime performing parties.

(c) The port where the goods are initially loaded on a ship; or the port where the goods are finally discharged from a ship; or

(d) Any place designated for that purpose in accordance with article 76, paragraph 1.

*Article 76. Choice of court agreements*⁴

1. If the shipper and the carrier agree that a competent court has jurisdiction to decide [disputes] [claims against the carrier]⁵ that may arise under this Convention, that court has non-exclusive jurisdiction.⁶

2. The jurisdiction of a court chosen in accordance with paragraph 1 of this article is exclusive for disputes between the parties to the contract only if the parties so agree and the agreement conferring jurisdiction:

(a) Is contained in a volume contract that clearly states the names and addresses of the parties and either (i) is individually negotiated; or (ii) contains a prominent statement that there is an exclusive choice of court agreement and specifies its location within the volume contract;

(b) [Clearly states the name and location of the chosen court] [Designates the courts of one Contracting State or one or more specific courts of one Contracting State];⁷ and

[(c) Is contained in the contract particulars.]

3. A person that is not a party to the volume contract is only bound by an exclusive choice of court agreement concluded in accordance with paragraph 2 of this article if:

(a) The court is in one of the places designated in article 75, paragraphs (a), (b) or (c);

[(b) That agreement is contained in the contract particulars of a transport document or electronic transport record issued in relation to the goods in respect of which the claim arises;]

(c) That person is given timely and adequate notice of the court where the action shall be brought and that the jurisdiction of that court is exclusive; and

⁴ Text as set out in paragraph 73 of A/CN.9/591, and accepted in substance by the Working Group in paragraph 84 of A/CN.9/591, with some drafting improvements to improve clarity.

⁵ The Working Group must decide which approach of the two alternatives in square brackets to choose with respect to draft article 76. Suggested drafting improvements to this text are noted in the relevant footnotes.

⁶ Sub-paragraphs 1 (a) and (b) of the text in paragraph 73 of A/CN.9/591 have been deleted as a drafting improvement, since the form requirement for draft article 76 is treated by adding a reference to draft article 76 to draft article 3.

⁷ The text appearing as alternative bracketed text is taken from article 3 (b) of the Convention on Choice of Court Agreements, 2005, and is suggested as it may be difficult to state the name and location of the chosen court with sufficient precision when agreeing on the choice of court in the volume contract.

(d) Applicable law as determined by the rules of private international law of the court seized⁸ permits that person to be bound by the exclusive choice of court agreement.

4. This article does not prevent a Contracting State from giving effect to a choice of court agreement that does not meet the requirements of paragraphs 1, 2 or 3 of this article. Such Contracting State shall give notice to that effect [to _____].⁹

5. (a) Nothing in paragraph 4 of this article or in a choice of court agreement effective under paragraph 4 of this article prevents a court specified in article 75[, paragraphs (a), (b), (c) or (d)] and situated in a different Contracting State from exercising its jurisdiction over the dispute and deciding the dispute according to this Convention.

(b) Except as provided in this chapter, no choice of court agreement is exclusive with respect to an action [against a carrier] under this Convention.¹⁰

*Article 77. Actions against the maritime performing party*¹¹

The plaintiff has the right to institute judicial proceedings under this Convention against the maritime performing party in a competent court within the jurisdiction of which is situated one of the following places:

(a) The domicile of the maritime performing party; or

(b) The port where the goods are initially received by the maritime performing party or the port where the goods are finally delivered by the maritime performing party[, or the single port in which the maritime performing party performs all of its activities with respect to the goods].¹²

⁸ The Working Group may wish to consider whether further clarification may be necessary to ascertain whether the “court seized” will necessarily be the competent court, or whether it may be another court.

⁹ The Working Group may wish to consider the interplay between this approach and the final clauses.

¹⁰ Separate paragraph provided for this provision in order to avoid making it subject to paragraph 4 of this article, as suggested by the Working Group in paragraph 80 of A/CN.9/591.

¹¹ Text from sixteenth session of Working Group, paragraph 73 of A/CN.9/591, accepted in substance in paragraph 84. A slight variation has been made to the chapeau for drafting purposes only in order to ensure that the chapeau mirrors that of article 75, and text has been suggested in paragraph (b) to accommodate maritime performing parties that operate in a single port. Further, the Working Group may wish to clarify the relationship between articles 76 and 77.

¹² The text in square brackets is proposed for addition in order to allow for situations in which a maritime performing party performs all of its activities in a single port. A similar change was made in draft article 20 concerning the liability of maritime performing parties.

*Article 78. No additional bases of jurisdiction*¹³

Subject to articles 80 and 81, no judicial proceedings under this Convention against the carrier or a maritime performing party may be instituted in a court not designated under articles 75, 76 or 77.

*Article 79. Arrest and provisional or protective measures*¹⁴

Nothing in this Convention affects jurisdiction with regard to provisional or protective measures, including arrest. [A court in a State in which a provisional or protective measure was taken does not have jurisdiction to determine the case upon its merits unless:

- (a) The requirements of this chapter are fulfilled; or
- (b) An international convention that applies in that State, according to its rules of application, so provides.]

Article 80. Consolidation and removal of actions

1. Except when there is an exclusive choice of court agreement that is valid under articles 76 or 81, if a single action is brought against both the carrier and the maritime performing party arising out of a single occurrence, the action may be instituted only in a court designated under both article 75 and article 77. If there is no such court, such action may be instituted in a court designated under article 77, subparagraph (b), if there is such a court.

2. Except when there is an exclusive choice of court agreement that is valid under articles 76 or 81, a carrier or a maritime performing party that institutes an action [[that would affect][the principal purpose of which is to affect] the rights of a person to select the forum under articles 75 or 77,][seeking a declaration of non-liability] shall at the request of the defendant, withdraw that action and may recommence it in one of the courts designated under articles 75 or 77, whichever is applicable, as chosen by the defendant.¹⁵

¹³ Text from sixteenth session of Working Group, paragraph 73 of A/CN.9/591, accepted in substance in paragraph 84, with a clarification concerning proceedings against the carrier or a maritime performing party.

¹⁴ Text from sixteenth session of Working Group, paragraph 73 of A/CN.9/591, accepted in substance in paragraph 84.

¹⁵ Text from sixteenth session of Working Group, paragraph 73 of A/CN.9/591, accepted in substance in paragraph 84. It might be necessary to arrange the provisions of time for suit for such cases when the original action was brought within the time period but the recommencement was not.

*Article 81. Agreement after dispute has arisen and jurisdiction when the defendant has entered an appearance*¹⁶

1. After the dispute has arisen, the parties to the dispute may agree to resolve it in any competent court.
2. A court in a Contracting State before which a defendant appears, without contesting jurisdiction in accordance with the rules of that court, has jurisdiction.

*Article 81 bis. Recognition and enforcement*¹⁷

1. A decision made by a court of one Contracting State that had jurisdiction under this Convention or by a court on which the parties agreed under article 81, paragraph 1, shall be recognized and enforced in another Contracting State in accordance with the law of the Contracting State where recognition and enforcement are sought.
2. A court in a Contracting State may refuse recognition and enforcement of a decision made in another Contracting State that is based on the application of article 76, paragraph 4.
3. A court in a Contracting State that has exclusive jurisdiction under article 76, paragraphs 2, 3 and 4, in a dispute under this Convention may refuse recognition and enforcement of a decision made by a court of another Contracting State in such dispute.

¹⁶ Text from sixteenth session of Working Group, paragraph 73 of A/CN.9/591, accepted in substance in paragraph 84. Opening phrase “Notwithstanding the preceding articles of this chapter” has been deleted as redundant, as references to article 81 have been added to articles 75, 76 and 80, and opening phrase of the second paragraph has been clarified from “a competent court” to “a court in a Contracting State”.

¹⁷ Text from sixteenth session of Working Group, paragraph 73 of A/CN.9/591, accepted in substance in paragraph 84. Drafting adjustments made to clarify paragraphs 1 and 2, but no change to the substance was intended. Paragraph 3 was added to respond to the request for clarification in paragraph 79 of A/CN.9/591.

F. Note by the Secretariat on the preparation of a draft convention on the carriage of goods [wholly or partly] [by sea] — Rights of suit and time for suit: document presented for information by the Government of Japan, submitted to the Working Group on Transport Law at its eighteenth session

(A/CN.9/WG.III/WP.76) [Original: English]

In preparation for the eighteenth session of Working Group III (Transport Law), the Government of Japan submitted to the Secretariat the document attached hereto as an annex with respect to rights of suit and time for suit in the draft convention on the carriage of goods [wholly or partly] [by sea]. The Government of Japan advised that the document was intended to facilitate consideration of the topics of rights of suit and time for suit in the Working Group by compiling the views and comments of various delegations into a single document for discussion by the Working Group.

The document in the attached annex is reproduced in the form in which it was received by the Secretariat.

ANNEX

Rights of suit and time for suit: document presented for information by the Government of Japan

I. Introduction

1. The Working Group exchanged preliminary views on the issues of rights of suit and time for suit, at its 9th session (April 2002, see A/CN.9/510, paras. 58 to 60), and it discussed the issues in detail at its 11th session (March-April 2003, see A/CN.9/526, paras. 149 to 182). Based on these discussions, the original text of the draft convention in A/CN.9/WG.III/WP.21 was revised in A/CN.9/WG.III/WP.32 and a few additional changes were made to the text in A/CN.9/WG.III/WP.56. These topics were discussed in an informal seminar held in London arranged on behalf of the Government of Italy ("London Seminar") in January 2006 to which all delegations and observers to the Working Group were invited. After the 17th session of the Working Group (April 2006), an informal questionnaire was circulated by the Japanese delegation among delegations and to observers of the Working Group. Responses were submitted by delegations from Canada, China, Denmark, Italy, Norway, Sweden, Switzerland and the United States. For the convenience of the Working Group, this document summarizes the discussions in the previous sessions of the Working Group and introduces preliminary views exchanged in the informal seminar and in responses to the informal questionnaire.

II. Rights of suit

A. General issues of the chapter

1. Necessity of the chapter on rights of suit

2. In the previous sessions of the Working Group, some delegations suggested the deletion of draft article 67 (see A/CN.9/WG.III/WP.56, footnote 237; and A/CN.9/526, paras.152 and 157). The informal questionnaire asked whether the draft convention should include a chapter on rights of suit. All responses answered in the negative suggested deletion of the entire chapter. One delegation, however, suggested that in addition to the deletion of the chapter, several principles set forth in draft article 67 (Variant A) should be incorporated into the provisions laid out in chapter 6 (liability of the carrier).

2. Relationship with other Conventions

3. It was pointed out at the London Seminar that the provisions on rights of suit might conflict with the rights of suit provided for under other transport law conventions when the contract of carriage was multimodal. For example, other transport law conventions may give rights of suit to a more limited number of persons than provided for in draft article 67. The informal questionnaire asked whether the draft convention should coordinate with other transport conventions on the issues of rights of suit. Responses to the informal questionnaire varied regarding this point. Many delegations that responded thought it unnecessary to coordinate with other transport conventions. One of them observed that draft article 27 already offered the solution. Some delegations were more cautious about the possible conflict with other conventions and sought coordination, although no specific solution was proposed on how to deal with the issue.

B. Draft article 67

4. Draft article 67 as set out in A/CN.9/WG.III/WP.56 provides as follows:

Article 67. Parties

Variant A

1. Without prejudice to articles 68 and 68 (b), rights under the contract of carriage may be asserted against the carrier or a performing party¹ only by:

(a) The shipper,² to the extent that it has suffered loss or damage in consequence of a breach of the contract of carriage;

(b) The consignee, to the extent that it has suffered loss or damage in consequence of a breach of the contract of carriage; or

¹ “Performing party” in Variant A should probably be replaced by “maritime performing party”.

² Article 34 provides that the “documentary shipper” is entitled to the shipper’s rights under Chapter 14. It might be questioned whether the “documentary shipper” should have the rights for suit.

(c) Any person to which the shipper or the consignee has transferred its rights, or that has acquired rights under the contract of carriage by subrogation under the applicable national law, such as an insurer, to the extent that the person whose rights it has acquired by transfer or subrogation suffered loss or damage in consequence of a breach of the contract of carriage.

2. In case of any passing of rights of suit through transfer or subrogation under subparagraph 1 (c), the carrier and the performing party are entitled to all defences and limitations of liability that are available to it against such third party under the contract of carriage and under this Convention.

Variant B

Any right under or in connection with a contract of carriage may be asserted by any person having a legitimate interest in the performance of any obligation arising under or in connection with such contract, when that person suffered loss or damage.

1. Scope of the draft article

5. Variant A covers only claims against the carrier or the (maritime) performing party.³ Variant B extends its coverage to claims against cargo interests. The informal questionnaire asked what the scope of the article should be. Responses to the question were divided. The majority viewed that claims against the shipper should also be covered. One delegate observed that it might be a good idea to allow only the carrier to sue the shipper under the provisions regarding shipper's obligations. The minority opposed such an extension of the scope. One delegation would like to limit the scope of draft article 67 to claims under draft articles 17 and 20 only.

2. "Loss or damage" requirement

6. Both variants require that the claimant should suffer "loss or damage". However, it was suggested in the previous sessions that this requirement might be problematic. For example, the requirement would be inappropriate for claims by a consignee that demanded the delivery of goods that are in the hands of the carrier (see A/CN.9/526, para.153).

7. At the informal seminar in London a more fundamental question was raised in relation to the "loss or damage" requirement. Draft article 67 was criticized as a confusion of substantive law (What should be ultimately established by the claimant in the litigation?) and of procedural law (What is necessary to be a proper plaintiff?). It was argued that, although it is necessary for the claimant to establish the "loss or damage" in order to win the suit, procedural law does not require such proof at the initial stage in order to file and maintain the lawsuit.

8. The informal questionnaire asked whether the requirement of "loss or damage" was appropriate. Some responses said that it was appropriate. One delegation assumed that the claim for delivery or enforcement of the right of control was covered in an exhaustive manner in other chapters, and since draft article 67 covered only an action for damages, the "loss or damage" required in draft article 67 was not problematic. Another delegation that responded suggested that the problem could be avoided if draft article 67 limited its scope to claims under draft articles 17

³ See footnote 1 above.

and 20. One delegation that responded suggested that the requirement might be unnecessary in that the party would not be interested in litigation if it had not suffered any loss or damage.

3. Choice of the variants

9. As for the choice between the two variants, most responses preferred Variant B, which offers a more general approach. One delegation proposed an additional paragraph to Variant B, which would read as follows: “Any right under or in connection with a contract of carriage may be asserted by any person having a legitimate interest in the performance of any obligation arising under or in connection with such contract, when that person suffered loss or damage.”

10. One delegation that responded preferred a reduced version of Variant A, which limited its scope to claims under draft articles 17 and 20.

4. Second paragraph of Variant A

11. Variant A contains a second paragraph which provides for defences and limitations with respect to the liability of the carrier and the (maritime) performing party⁴ in the case of a transfer of the rights of suit or the acquisition of the rights of suit through subrogation. There has been no substantive discussion about this paragraph in the previous sessions of the Working Group or in the London Seminar.

12. The informal questionnaire asked for comments on the paragraph and inquired whether the same paragraph was also necessary in Variant B. Some responses proposed the deletion of this paragraph. One of them argued that the issue should be dealt with in chapter 12 (transfer of rights). Some delegates observed otherwise, and argued that the same paragraph should be included if Variant B is chosen.

C. Draft article 68

13. Draft article 68 as set out in A/CN.9/WG.III/WP.56 provides as follows:

*Article 68. When negotiable transport document or negotiable
electronic transport record is issued*

In the event that a negotiable transport document or negotiable electronic transport record is issued:

(a) The holder is entitled to assert rights under the contract of carriage against the carrier or a performing party, irrespective of whether it suffered loss or damage itself; and

(b) When the claimant is not the holder, it must, in addition to proving that it suffered loss or damage in consequence of a breach of the contract of carriage, prove that the holder did not suffer the loss or damage in respect of which the claim is made.

14. Draft paragraph (a) allows the holder to assert his or her rights against the carrier whether or not the holder suffered loss or damage. The explanatory note to the original draft is as follows: “It seems that under many legal systems claimants

⁴ See footnote 1 above.

under a bill of lading are not confined to claiming their own loss. This article does not provide that only such holder has the right to sue” (see A/CN.9/WG.III/WP.21, para. 204). In a previous session of the Working Group, it was widely accepted that this principle is generally recognized in many jurisdictions (see A/CN.9/526, para. 160).

15. Draft paragraph (b) includes two different components: (1) the claimant other than the holder who is referred to under draft article 67 can make a claim against the carrier even when a negotiable transport document or a negotiable electronic transport record is issued, and (2) in this case, the claimant should prove, in addition to the loss or damage it has suffered, that the holder did not suffer the loss or damage. This provision is probably more controversial than draft paragraph (a). The Working Group agreed at its 11th session that the issue might need to be further discussed at a later stage (see A/CN.9/526, para. 162).

16. The first question asked in the informal questionnaire was whether it was necessary or desirable that the draft convention deal with problems such as those addressed under current draft articles 68 (a) and (b). All responses answered in the negative. One delegate thought draft article 68 (a) was inconsistent with its domestic civil procedure law and if draft article 68 (a) were deleted, draft article 68 (b) would become unnecessary.

17. The informal questionnaire further invited any suggestion regarding both paragraphs. Since most delegations that responded supported the deletion of draft article 68, only a few drafting suggestions were made to the current text. One delegation noted that the carrier was exposed to the danger of double payment under draft article 68 (a) when a person other than the holder that suffered the ultimate loss (e.g., the owner of the goods which are damaged) claimed against the carrier after the carrier had compensated the holder.⁵ One delegation suggested that the “holder” should be treated simply as a consignee in the sense of draft article 67 (1)(b).

III. Time for suit

A. General issues of the chapter

18. The necessity of the chapter on time for suit was never questioned in the previous sessions of the Working Group, although certain provisions might possibly be deleted. All responses to the informal questionnaire unanimously agreed in this regard.

⁵ The original draft has a second sentence, which is intended to deal with this situation, and which reads as follows: “If such holder did not suffer the loss or damage itself, it is deemed to act on behalf of the party that suffered such loss or damage.” The original draft’s wording was criticized and deleted during the 11th session (see A/CN.9/526, para. 161).

B. Draft article 69

19. Draft article 69 as set out in A/CN.9/WG.III/WP.56 provides as follows:

Article 69. Limitation of actions

Variant A

The carrier⁶ is discharged from all liability under this Convention if judicial or arbitral proceedings have not been instituted within a period of [one] year. The shipper⁷ is discharged from all liability under chapter 8 of this Convention if judicial or arbitral proceedings have not been instituted within a period of [one] year.

Variant B

All [rights] [actions] under this Convention are extinguished [time-barred] if judicial or arbitral proceedings have not been commenced within the period of [one] year.

20. In previous sessions, several different issues have been addressed in relation to draft article 69.

1. Which claim should be subject to the time limitation of this convention?

21. Both Variant A and Variant B limit the time for suit not only regarding claims against the carrier or the maritime performing party, but also with respect to those against the cargo interest.⁸ It was discussed at some length at the 11th session of the Working Group whether this approach is appropriate (see A/CN.9/526, para. 166). The Working Group may also wish to consider whether this approach should still be maintained when draft article 67 covers only claims against the carrier or the maritime performing party (see A/CN.9/526, para. 154). It should also be noted that the Working Group decided at its 14th session that the Convention should regulate the jurisdiction and arbitration of claims only against the carrier or the maritime performing party (see A/CN.9/572, paras. 116-117).

22. Second, claims may arise out of the contract of carriage that are not based on the provisions of the draft convention, for example, the carrier's claim against the shipper for freight. In addition, there are several obligations under the draft convention for which the consequences are not provided and which are thus left to applicable national law. Should these claims be subject to the time limitation?

⁶ The reference to "maritime performing party" may be added to the first sentence of Variant A although article 20 (1) possibly makes it unnecessary.

⁷ The reference to "a person referred to in article 34" may be added to the second sentence of Variant A although draft article 34 possibly makes it unnecessary. However, the current draft article 34 does not refer to the immunities in chapter 15 and the reference should be added.

⁸ To be more precise, there seems to be a slight difference in coverage between Variant A and Variant B with regard to actions against the cargo interest. For example, the claim for reimbursement against the controlling party under draft article 57 (2) is not subject to draft article 69 under Variant A, while it is under Variant B. The Working Group may wish to consider whether a time limit for those claims also needs to be imposed.

23. In the responses to the informal questionnaire, most delegations supported the suggestion that claims against the shipper should also be covered, while one delegation that responded took the opposing view. One delegation noted that while it might be advisable that draft article 69 should cover claims against shippers etc., the limitation period should be carefully chosen for such claims. It was suggested that in the case of total disaster of the ship caused by the shipper's negligence, the investigation to uncover the real cause of the accident would likely take a long time.

24. Most delegations that responded did not explicitly answer whether only the claims under the draft convention should be covered. One delegation responded expressly that claims under applicable national law should not be covered. Another delegation suggested that the limitation should apply to all rights and actions arising out of the contract of carriage.

25. One delegation that responded proposed that draft article 69 should also cover actions against the ship, as is the case in the Hague-Visby Rules. It was also suggested that a corresponding change in connection with the shipper might be necessary so that the draft article would also cover claims against the cargo interest.

2. Choice of variants and wordings

26. There are several possible formulations for the time limitation of claims. Article 3 (6) of the Hague-Visby Rules adopts the expression "carrier shall be discharged from all liability" while article 20 (1) of the Hamburg Rules states "any action is time-barred". Although the question is more or less a matter of expression, it was pointed out that there are several substantive questions related to the choice of variants and wording.

27. These substantive questions regarding the wording of the text include the following:

(a) *The Nature of the Limitation.* The distinction between "limitation period" and "extinguishment of right" was emphasized in a previous session of the Working Group. It was suggested that the difference might affect the applicability of the suspension of the time period or the choice of applicable law (see A/CN.9/526, para.167).

(b) *Availability of the Claim for Set-off.* If the draft convention provides that "the actions are time-barred", it might be ambiguous whether the party can still use the "time-barred" claim by means of set-off without bringing an action. In fact, the Budapest Convention on the Contract for the Carriage of Goods by Inland Waterway, 2000 (the CMNI), which uses the term "time-barred", contains an additional provision to clarify the consequence: "A right of action which has become barred by lapse of time may not be exercised by way of counterclaim or set-off."⁹ In contrast, if the Working Group adopts such expressions as "the carrier is discharged" or "the rights are extinguished", it is probably unnecessary to address the issue of possible set-off. (It is apparent that an extinguished claim cannot be used even by means of set-off.)

28. The informal questionnaire asked which approach, the "limitation period" or "extinguishment of right" approach, was preferable, as well as which variant and which wording was preferable. Most responses expressed a preference for the

⁹ CMNI Article 24 (5). The Convention on the Contract for the International Carriage of Goods by Road, 1956 as amended by the 1978 Protocol (CMR) has a similar provision (Article 32 (5)).

“limitation period” approach. One response proposed the following clarification to avoid any doubts concerning the consequences of limitation: “Upon limitation the claimant loses its right to the fulfilment of the claim”. One response preferred the “limitation period” approach because it believed that the time-barred claim could be used by means of set-off. In contrast, one delegation that responded preferred the “extinguishment of right” approach to make the time-bar absolute, suggesting that, according to its national law, a limitation period could be easily extended by the mere fact that the party claimed compensation. One delegation noted that “limitation period” was not a term of art in civil law jurisdictions.

29. As for the choice of the variants, responses to the informal questionnaire were evenly divided. Some delegations preferred Variant B and chose the expression “actions are time-barred”. The availability of the time-barred claim by means of set-off could be questioned if these wordings are adopted (see above). Others supported Variant A. One of the respondents noted that the expression used in the Hague and Hague-Visby Rules (Variant A) did not seem to have given rise to any problems.

3. Suspension of time period

30. It might be necessary to consider whether and how the issue of the “suspension of time period” should be addressed in the draft convention. Should the draft convention provide its own rules regarding the issue or should the issue be left to national law? In the latter case, which law should govern the problem? For example, CMNI article 24 (3) clarifies that the law applicable to the contract of carriage governs the issue of the suspension and the interruption of the limitation period (see also CMR article 32 (2) and (3)).

31. The informal questionnaire asked how the draft convention should treat the issue of suspension. Most delegations that responded answered that the issue of the suspension of the time period should be left to national law, while one delegation suggested that the draft convention should regulate the issue. However, some delegations that responded thought that it was desirable for the draft convention to clarify at least which law was applicable to the question, and it was suggested that the law governing the contract of carriage should apply. Some delegations that responded reserved their position.

4. Appropriate time period

32. Finally, there is the question of the appropriate time period. Article 3 (6) of the Hague-Visby Rules provide for one year, while article 20 (1) of the Hamburg Rules allows for two. In the responses to the informal questionnaire, most delegations answered that one year was sufficient. One delegation preferred two years, but it was ready to compromise if the Working Group preferred otherwise. Another delegation suggested special consideration for a claim against the carrier, depending on the type of the claim.

C. Draft article 70

33. Draft article 70 as set out in A/CN.9/WG.III/WP.56 provides as follows:

Article 70. Commencement of limitation period

The period referred to in article 69 commences on the day on which the carrier has completed delivery of the goods concerned pursuant to article 11 (4) or 11 (5) or, in cases in which no goods have been delivered, on the [last] day on which the goods should have been delivered. The day on which the period commences is not included in the period.

1. A claim against the carrier

34. Draft article 70 provides for the commencement day of the limitation period. There was a long discussion in a previous session of the Working Group about whether the commencement date should be the date of the actual delivery (see A/CN.9/526, para. 170). One might support the “actual receipt approach” otherwise the time period begins to run before the consignee can check the condition of the goods in the case of delay. However, concerns were raised against this approach. It was pointed out that the actual delivery might be delayed by unilateral action of the consignee or by the local customs authority. In addition, the “actual receipt approach” cannot be maintained in a case where all the goods were lost. The current draft convention includes the second part of the first sentence which deals with the situation.

35. If the Working Group rejects the “actual receipt approach”, one possible alternative might be that the time period always commences from “the time of delivery specified in article 11 (4) or 11 (5)”. If this approach is taken, the second part of the first sentence becomes unnecessary.¹⁰ However, one might have a concern whether this approach provides an appropriate solution in cases of delay.

36. The Hague-Visby Rules define the commencement date in article 3 (6) as the date “of their [goods] delivery or of the date when they [goods] should have been delivered,” while article 20 (2) of the Hamburg Rules define it as “the day on which the carrier has delivered the goods or part thereof or, in cases where no goods have been delivered, on the last day on which the goods should have been delivered.” The two look like a combination of the “actual” and “contractual” approaches.

37. In the response to the informal questionnaire regarding the appropriate commencement date for a claim against the carrier, the majority answered that the date of actual delivery was preferable. One delegation that responded thought that, to avoid unnecessary disputes, the periods should commence when the goods have arrived at the place of delivery and the notice is sent to the consignee that the goods are ready for delivery. Another delegation preferred “the time of delivery specified in article 11 (4) or 11 (5)”. Further, one delegation preferred the contractual approach as a starting point, while suggesting that the day of actual delivery should prevail if it is the later of the two. One delegation simply supported the wording of current draft text. However, it was suggested that the current wording, “carrier has completed delivery of the goods concerned pursuant to article 11 (4) or 11 (5),” is

¹⁰ The “actual receipt” is not completely abandoned even under this approach when there is neither contractual agreement nor customs or usages for time of delivery.

problematic when, for instance, the goods are delivered prior to the date agreed in the contract of carriage.

38. Almost all delegations that responded to the informal questionnaire agreed that should the actual delivery approach be taken, it should be supplemented with a special rule in the case of total loss of the goods. In this case, it was suggested that the date on which the goods were supposed to be delivered should be the commencement date. It was also suggested by one delegation that the same should also apply when the consignee does not take delivery.

2. A claim against a maritime performing party

39. It was argued at the London Seminar that the notion of “delivery” should be clarified in connection with a possible claim against a maritime performing party. It was suggested that the limitation period for a claim against a maritime performing party should run from the date of delivery of the goods by the maritime performing party to the subsequent carriers rather than the date of final delivery to the consignee.

40. Taking this suggestion into account, the informal questionnaire asked whether the commencement date for the claim against a maritime performing party should be different from the action against a carrier. All responses agreed that the commencement date should be the same as with respect to the contracting carrier. It was explained that in the case of multimodal transport, the damage to the goods might not be detected until they reach the final destination and the limitation periods should commence at that point even for a claim against the maritime performing party.

3. A claim against cargo interest

41. In a previous session of the Working Group, doubts were raised as to whether the time of delivery was relevant for the limitation period for claims against the shipper or other cargo interest (see A/CN.9/526, para. 173). However, no specific alternative commencement date was suggested for claims against the person other than the carrier. The informal questionnaire asked whether it was appropriate to have the same commencement date for claims against the shipper and the carrier. The majority answered that the commencement date should be the same. One delegation expressed a different view that the limitation period for a claim against the shipper should begin from the date when the loss or damage occurred.

4. Other issues

42. Some delegations that responded to the informal questionnaire expressed a concern with respect to the bracketed word in the first sentence of draft article 70. One of them proposed the deletion of the word “last”, and the inclusion of the following text as the last part of the first sentence: “*on the day in which delivery of the goods should have been completed*”.

D. Draft article 71

43. Draft article 71 as set out in A/CN.9/WG.III/WP.56 provides as follows:

Article 71. Extension of limitation period

The person against which a claim is made may at any time during the running of the period extend that period by a declaration to the claimant. This period may be further extended by another declaration or declarations.

1. Difference with Hague-Visby Rules

44. A provision that enables the parties to extend the limitation period exists under the Hague-Visby Rules (article 3 (6)) and the Hamburg Rules (article 20 (4)). There is, however, a slight difference between them. The current draft text is basically identical to the latter. The difference is as follows: first, the Hamburg Rules require a “declaration” while the Hague-Visby Rules require an “agreement”; and second, the extension might be allowed even after the lapse of the time period under the Hague-Visby Rules, while the current draft and the Hamburg Rules clearly deny that possibility.

45. In response to the informal questionnaire, most delegations that responded preferred “declaration” to “agreement”, while some delegates took the opposing view. One delegation suggested that an extension after the lapse of time should be possible.

2. Form requirement

46. Draft article 3 provides the form requirement for the declaration under draft article 71. Although the treatment is the same as in article 20 (4) of the Hamburg Rules, it may be questioned whether it is consistent with the treatment of agreement for jurisdiction after a dispute has arisen (draft article 81, as set out in A/CN.9/591, para. 73).¹¹ In response to the informal questionnaire, most delegations that responded saw the form requirement under the current draft of the convention as appropriate while one suggested that an oral declaration might be sufficient.

E. Draft article 72

47. Draft article 72 as set out in A/CN.9/WG.III/WP.56 provides as follows:

Article 72. Action for indemnity

An action for indemnity by a person held liable under this Convention may be instituted even after the expiration of the period referred to in article 69 if the indemnity action is instituted within the later of:

(a) The time allowed by applicable law in the jurisdiction where proceedings are instituted; or

¹¹ It was confirmed that no form requirement is necessary in article 81. See A/CN.9/591, paras. 61 to 62 and 64.

(b) Variant A of paragraph (b)

90 days commencing from the day when the person instituting the action for indemnity has either

- (i) settled the claim; or
- (ii) been served with process in the action against itself.

Variant B of paragraph (b)

90 days commencing from the day when either

- (i) the person instituting the action for indemnity has settled the claim; or
- (ii) a final judgement not subject to further appeal has been issued against the person instituting the action for indemnity.

48. Draft article 72 provides for a special extension of the time period with respect to recourse action. The special rule is necessary to ensure, for example, that the carrier has sufficient time to bring an action against the sub-carrier when the action against the carrier was brought immediately before a lapse of the time period. A similar rule exists under both the Hague-Visby Rules (article 3 (6 bis)) and Hamburg Rules (article 20 (5)).

49. All responses to the informal questionnaire supported the basic substance of the provision. However, one delegation that responded thought it necessary for the article to cover situations where the shipper seeks indemnity from the carrier after having been held liable by the consignee pursuant to the underlying contract between the shipper and the consignee.

50. There are two variants of draft paragraph (b) which provide for a different commencement date for the additional 90 days. Variant A provides for essentially the same rule as in both the Hague-Visby Rules and the Hamburg Rules. Variant B, which is a new rule, was introduced based on the suggestion at the 11th session of the Working Group that, in certain civil law countries, it was not possible to commence an indemnity action until after the final judgement in the case has been rendered (see A/CN.9/526, para. 176).

51. Most responses to the informal questionnaire preferred Variant A, while some supported Variant B. One delegate stressed that if Variant B were taken, the third party from whom indemnity was being sought might not be approached for many years after the accident, and many things including evidence, witnesses and memories will be lost during the period. In addition, it was also suggested that although Variant B was drafted to meet the concern of certain civil law countries where an indemnity action cannot be commenced until after the final judgement is rendered, paragraph (a) of draft article 72 gives adequate protection.

F. Draft article 73

52. Draft article 73 as set out in A/CN.9/WG.III/WP.56 provides as follows:

Article 73. Counterclaims

A counterclaim by a person held liable under this Convention may be instituted even after the expiration of the period referred to in article 69 if it is instituted within 90 days commencing from the day when the person making the counterclaim has been served with process in the action against itself.

53. This provision is based on the suggestion at the 11th session of the Working Group that the same consideration should apply to counterclaims as to recourse actions (see A/CN.9/526, para. 177). The informal questionnaire asked whether the draft convention should address the issue of counterclaims and whether the current draft was appropriate for that purpose. Some responses suggested that the draft article should be deleted. One delegation questioned whether there was any counterclaim that deserved extension under this provision. Others that responded thought that the provision was necessary and expressed their basic support for the current draft of the text.

54. There were a number of drafting suggestions. First, one delegation that responded observed that the expression “a counterclaim ... may be instituted” gave rise to doubts as to whether the counterclaim should be made in the same proceedings or in separate proceedings, and suggested that it be clarified that the former is the case. Second, it was proposed that the words “or within the longer period allowed by the *lex fori*” should be added at the end of the sentence because in certain jurisdictions a counterclaim may be made only at the time of entering an appearance, and the period between the service of process and the entry of an appearance may be more than 90 days. Finally, a question was raised regarding the scope of the article. One delegation suggested that the scope of draft article 73 should be limited to counterclaims that were instituted for set-off. Another delegation noted that the current draft seemed far-reaching and that an additional condition should be added to the scope of the counterclaim. It proposed the addition of the following text:

The limitation of a claim does not mean that a right of counterclaim is extinguished, provided that the claim against which the counterclaim is made derives from the same legal context as the time-barred claim and has arisen prior to this claim becoming time-barred.

G. Draft article 74

55. Draft article 74 as set out in A/CN.9/WG.III/WP.56 provides as follows:

Article 74. Actions against the bareboat charterer

[If the registered owner of a ship defeats the presumption that it is the carrier under article 40 (3), an action against the bareboat charterer may be instituted even after the expiration of the period referred to in article 69 if the action is instituted within the later of:

(a) The time allowed by the applicable law in the jurisdiction where proceedings are instituted; or

- (b) 90 days commencing from the day when the registered owner [both
 - (i) proves that the ship was under a bareboat charter at the time of the carriage; and]
 - [(ii)] adequately identifies the bareboat charterer.]

56. This draft article addresses the concern that the limitation period may expire before a claimant has identified the bareboat charterer that is the responsible “carrier” under draft article 40 (3). However, the question of whether article 40 (3) should be deleted or retained is still pending and if the Working Group decides to delete it, then this article should also be deleted.

57. The informal questionnaire asked whether draft article 74 is acceptable assuming that draft article 40 (3) remains in the text. Some responses supported the substance of draft article 74 while others opposed it. One delegate proposed the following new text on the assumption that draft article 40 (3) is redrafted as proposed in A/CN.9/WG.III/WP.70, para.3:

“If the contract particulars fail to indicate the name and address of the carrier and the plaintiff has requested the registered owner to properly identify the carrier

(a) an action against the registered owner may be instituted within 90 days commencing from the date when the request to identify the carrier is made, and

(b) an action against the carrier may be instituted within 90 days commencing from the date when the registered owner has properly identified the carrier.”

H. Possible additional article with regard to the removal of action pursuant to draft article 80 (2)

58. It was suggested at the 16th session of the Working Group that the draft convention should provide for the treatment of the time limitation for suit in connection with the removal of actions pursuant to draft article 80 (2) (see A/CN.9/591, para. 57).

59. One might doubt, however, whether a special rule is necessary to deal with this situation. It was generally accepted that a typical action, which can be removed under draft article 80 (2), is a declaratory action to deny the carrier’s liability and does not include “legitimate” actions against the shipper such as a claim for liability under chapter 8 (see A/CN.9/591, paras. 57-59). Suppose that the carrier brings a declaratory action for non-liability against the consignee before the time period has expired and the consignee demands a removal of the action. The carrier brings a new action in another forum specified in draft article 75 or 77 after the time period has expired. Does the carrier want to extend the limitation period in this situation? It is also not clear whether the cargo interest deserves the extension because it could have brought an action against the carrier at any time in the forum specified in draft article 75 or 77. A careful examination seems necessary as to the question of whether any party should have a legitimate interest for the extension of the time limitation in connection with draft article 80 (2).

60. The informal questionnaire asked whether it was necessary to have a special rule in connection with the removal of actions pursuant to draft article 80 (2) and what such a special rule should provide. While some delegations reserved their position, many delegations that responded did not think it necessary to include such a provision. In contrast, one delegation explicitly supported the additional article with regard to the removal of actions under draft article 80 (2). It was suggested that such an article should give the carrier reasonable time (e.g., 90 days) to bring an action before the competent court which the cargo interest has chosen.

G. Note by the Secretariat on the preparation of a draft convention on the carriage of goods [wholly or partly] [by sea] — Procedure for amendment of limitation amounts — drafting proposal by the Government of the United States of America, submitted to the Working Group on Transport Law at its eighteenth session
(A/CN.9/WG.III/WP.77) [Original: English]

In preparation for the eighteenth session of Working Group III (Transport Law), the Government of the United States of America submitted to the Secretariat the proposal attached hereto as an annex with respect to the procedure for the amendment of the limitation amounts in the draft convention on the carriage of goods [wholly or partly] [by sea]. The Government of the United States of America advised that the document was intended to facilitate consideration of the topic of the procedure for the amendment of limitation amounts in the Working Group by proposing revised text for draft article 104 of the draft convention.

The document in the attached annex is reproduced in the form in which it was received by the Secretariat.

ANNEX

Procedure for Amendment of Limitation Amounts

General comment

1. As discussed in A/CN.9/WG.III/WP.34, the United States supports an expedited procedure to amend limits which avoids the full panoply of formalities normally required to amend the draft Convention. At the same time, the United States is of the view that it is important to ensure that such amendments to liability limits reflect a broad consensus on the need for a change and that the procedure ensures a stable, predictable commercial environment regarding risk management arrangements. Unless otherwise indicated, the following comments relate to draft article 104 of A/CN.9/WG.III/WP.56.

Draft paragraph 2

2. Initiating a change to the liability limits should require the support of at least half of the parties to the draft Convention. The number of parties does not necessarily correlate to the percentage of cargo volume or cargo value covered by the draft convention, nor of a country's number of transport providers. A requirement of only one quarter of the parties would permit the initiation of the process to change a material term of a formal treaty without insuring that there is a consensus on the need for change, particularly amongst those most affected. Requiring the support of half of the parties does not tie the change to a cargo volume or value requirement, but it does insure that the need for change will be a widely held view. We believe that review of limits agreed in a formal treaty should not be undertaken absent such a widely held view. Several comparable treaties require the support of at least half of the parties to initiate an amendment. In addition to the 2002 Protocol to the Athens Convention, the 1990 Protocol to the Athens Convention, the Convention for Liability and Compensation for Damage in

Connection with the Carriage of Hazardous and Noxious Substances by Sea, and the 1996 Protocol to the Convention on Limitation of Liability for Maritime Claims adopt such a procedure.

3. Under existing practices in international private law, significant changes to concluded texts are usually produced by the same multilateral bodies that formulated the original text, acting through their general membership (and, in the case of UNCITRAL, observer States), and not only Contracting States to a particular treaty (although States party can also always agree to amendments as between themselves, or *inter se*). UNCITRAL, for example, amended its first convention (the 1974 Convention on the Limitation Period in the International Sale of Goods) not by action of the Contracting States but by the Commission elaborating a 1980 amending Protocol to the Convention.

Draft paragraph 4

4. Similarly, strict voting procedures tend to politicize issues, and are not in line with the Commission's consistent practice of making decisions by consensus, which is a more appropriate method for the formulation of uniform rules on private law matters. Given that the initial limitation adopted in draft article 64 will have been adopted by consensus, any amendment should be adopted in the same manner. Any amendment adopted by the Commission should, following the normal practice, be referred to the General Assembly for approval upon the recommendation of the Commission.

Draft paragraph 5

5. The need for and utility of this provision requires further discussion. Our current view is that such a provision is not necessary.

Draft paragraph 6

6. The relevant date for permitting the amendment procedure should be seven years after the draft convention enters into force and seven years after prior amendments under this procedure. Given the informal nature of this amendment procedure, there should be restrictions on the level of increases that can be approved. We suggest 21% for any single adjustment, and no more than a cumulative increase of 100%.

Draft paragraphs 7 and 8

7. If the amendment has been adopted by consensus at a meeting open to Contracting States, UNCITRAL members and observer States, and subsequently approved by the General Assembly, there is no need to insert yet another approval process before the amendment enters into force. Also, 18 months is an unnecessarily long period of time between approval by the General Assembly and entry into force. This amendment procedure only applies to the amendment of the liability amount. It should not take many months for a Contracting State to study that one figure and determine whether it supports it. Twelve months should be sufficient, provided that at least a certain number of Contracting States have ratified, accepted or approved the amendment by that time. (The exact number should probably be the same as is required for entry into force of the draft convention under draft article 101.)

Draft paragraph 9

8. The United States could not accept a provision that would bind all Contracting States to an amendment of the limitation amount unless they denounce the entire draft convention. A Contracting State should be able to denounce a specific amendment rather than the entire convention. As this is intended to be an expedited amendment procedure, the time after which it will enter into force for a Contracting State if that State does not denounce it may be relatively short and not sufficient for some States to comply with their domestic legal procedures. A State may have to denounce the amendment simply because it had not concluded its internal approval process. Therefore, the amendment procedure should allow for a State to withdraw its denunciation at anytime.

9. Attached below is our proposed text of draft article 104. We appreciate the opportunity to comment on this important subject.

U.S. Proposal for Article 104**Article 104. Amendment of limitation amounts**

1. Without prejudice to the provisions of article 103, the special procedure in this article shall apply solely for the purpose of amending the limitation amount set out in article 64, paragraph 1, of this Convention.

2. At the request of at least one half of the Contracting States to this Convention to amend the limitation amount specified in article 64, paragraph 1, of this Convention and subject to paragraph 5(a) of this article, the depositary shall convene a meeting of all Contracting States and all Members of the United Nations Commission on International Trade Law to consider whether the limitation amount should be modified.

3. The meeting shall take place on the occasion of and at the location of the next session of the United Nations Commission on International Trade Law.

4. Except as provided in paragraph 5 of this article, the normal procedures of the United Nations Commission on International Trade Law and the United Nations General Assembly shall apply to this meeting and to any recommendations resulting from it.

5. (a) No amendment of the limit under this article may be considered less than seven years from the date of entry into force of this Convention or less than seven years from the date of entry into force of a previous amendment under this article.

(b) No limit may be increased or decreased by more than twenty-one per cent in any single adjustment.

(c) No limit may be increased or decreased by more than two times the original amount, cumulatively.

6. Any amendment adopted in accordance with paragraphs 2 through 5 of this article shall enter into force twelve months after either its adoption or its ratification, acceptance, or approval by [x] Contracting States, whichever is later.

7. All Contracting States shall be bound by the amendment, unless they denounce the amendment in accordance with article 105 before the amendment

enters into force. Such denunciation shall take effect when the amendment enters into force, and may be withdrawn at any time.

8. When an amendment has been adopted but has not yet entered into force because the twelve-month period has not yet expired, a State which becomes a State Party during the twelve-month period shall be bound by the amendment when the amendment enters into force or when this Convention enters into force for that State, if later.

H. Note by the Secretariat on the preparation of a draft convention on the carriage of goods [wholly or partly] [by sea] — Relation with other conventions, submitted to the Working Group on Transport Law at its eighteenth session

(A/CN.9/WG.III/WP.78) [Original: English]

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I. Introduction

1. In preparation for the eighteenth session of Working Group III (Transport Law) and with a view to facilitating the Working Group's consideration of chapter 21 containing the final clauses of the draft convention on the carriage of goods [wholly or partly] [by sea], the Secretariat has prepared a note on the relation between the draft convention and other international legal instruments, taking into consideration also various views and comments expressed on this topic, and, in particular, on the door-to-door scope of application of the draft convention. This note presents information on the relation between the draft convention and other instruments relating to international carriage of goods by sea; the relation between the draft convention and instruments relating to non-maritime international carriage

of goods; and the relation between the draft convention and international legal instruments not relating to the carriage of goods.

2. The Working Group may wish to note that issues relating to door-to-door transport, and possible conflicts between the draft convention and other international instruments governing carriage by modes other than sea carriage were already discussed in document A/CN.9/WG.III/WP.29. The Working Group may wish to consider that document in conjunction with the present note, bearing in mind, however, that the analysis contained in document A/CN.9/WG.III/WP.29 was made at a time when the draft convention did not explicitly limit direct actions under the draft convention to actions between the contractual parties to the overarching maritime contract of carriage, which by itself has limited the scope for possible conflicts with other conventions, as compared to the situation contemplated in document A/CN.9/WG.III/WP.29.

II. Relation between the draft convention and other instruments relating to international carriage of goods by sea

3. The draft convention covers the entire subject matter of the International Convention for the Unification of Certain Rules of Law relating to Bills of Lading, 1924 (the “Hague Rules”),¹ of the Protocol to Amend the International Convention for the Unification of Certain Rules of Law Relating to Bills of Lading signed at Brussels on 25 August 1924, 1968 (usually referred to, in conjunction with the previous instrument, as the “Hague-Visby Rules”),² and of the United Nations Convention on the Carriage of Goods by Sea, 1978 (the “Hamburg Rules”).³

4. As their subject matter coincides, the operation of the draft convention among its parties is incompatible with the operation, among the same parties, of other, pre-existing treaties relating to the international carriage of goods by sea. It was therefore deemed advisable to insert in the final clauses of the draft convention a provision requiring a State, which intended to become a party to the draft convention to denounce certain named treaties relating to international carriage of goods by sea, to which it might be a party. Accordingly, article 102 of the draft convention requires a State wishing to become a party to the draft convention to denounce the Hague Rules, the Hague-Visby Rules or the Hamburg Rules. Its text was inspired by articles 99, paragraphs 3 and 6, of the United Nations Convention on Contracts for the International Sale of Goods (the “United Nations Sales Convention”)⁴ and by article 31 of the Hamburg Rules.

5. The approach adopted in draft article 102 has the advantage of providing maximum certainty on the applicable law, since after its denunciation a treaty would not have any force of law in the denouncing State. However, it has been suggested that this approach might have a potential disadvantage, since the denunciation of the Hague, Hague-Visby or Hamburg Rules would deprive the carriers and shippers in the denouncing State of the benefit of a uniform legal regime with a number of contracting partners in States which had not yet become parties to the draft

¹ League of Nations, *Treaty Series*, vol. CXX, p. 155.

² United Nations, *Treaty Series*, vol. 1412, No. 23643.

³ United Nations, *Treaty Series*, vol. 1695, No. 29215.

⁴ United Nations, *Treaty Series*, vol. 1489, No. 25567.

convention, but were parties to another instrument relating to international carriage of goods by sea.

6. In that connection, the Secretariat brought to the attention of the Working Group the alternative approach that had been adopted in article 55 of the Convention for the Unification of Certain Rules Relating to International Carriage by Air, 1999 (the “Montreal Convention”)⁵ (see A/CN.9/WG.III/WP.56, footnote 302). The approach taken in article 55 of the Montreal Convention, which is based on article 30 of the Vienna Convention on the Law of Treaties,⁶ does not require a formal denunciation of pre-existing treaties, but rather holds that the Montreal Convention should prevail between States parties that are also parties to another convention on the same subject. Under this approach, the State becoming a party to the draft convention would apply the new regime in respect of carriage originating from or destined to those States that had already become a party to the draft convention, in accordance with draft article 8. However, the same State would apply the previous regime in respect of contracts of carriage to which those previous conventions, under their own terms, would apply if the factors that determine their application were connected to other States that were still parties to the previous conventions. The new regime would progressively substitute the older ones, as the various States became party to the draft convention.

7. However, it should also be noted that, as a consequence of this approach, a dual uniform legal regime, corresponding to the new and the previous instruments, might come into existence in a State party to the draft convention. The approach taken in the Montreal Convention might also lead to some difficulties in countries that, according to their constitutional laws, provide for direct application of international treaties and conventions upon ratification and internal promulgation. In those countries, the later treaty would automatically become part of the domestic legal system, displacing the earlier regime.

III. Relation between the draft convention and instruments relating to non-maritime transport conventions

8. The relation between the draft convention and other instruments relating to international carriage of goods by modes of transport other than by sea has been discussed at length by the Working Group, with particular regard to the intended scope of application of the draft convention in relation to door-to-door transport (see A/CN.9/510, paras. 26-32; A/CN.9/526, paras. 219-267; and A/CN.9/544, paras. 20-50).

9. At its ninth session (New York, 15-26 April 2002), the Working Group considered the desirability and feasibility of a door-to-door scope of application in the draft convention (see A/CN.9/510, paras. 26-32). It was suggested that the inclusion of door-to-door operations would better serve the needs of the trade

⁵ United Nations, *Treaty Series*, vol. 2242, No. 39917.

⁶ United Nations, *Treaty Series*, vol. 1155, No. 18232. Article 30, paragraph 3, of the Vienna Convention on the Law of Treaties provides that when all parties to an earlier treaty are parties to a later treaty on the same subject matter, “the earlier treaty applies only to the extent that its provisions are compatible with those of the later treaty.” Pursuant to paragraph 4 of the same article, the same rule applies as between states parties to both treaties, when the parties to the later treaty do not include all parties to the earlier one.

community since most contracts of carriage by sea, especially in containerized traffic in the liner trade, included a non-sea leg (see A/CN.9/510, para. 30). However, it was added that, in adopting a door-to-door approach, the draft convention should not displace non-maritime transport conventions of mandatory application, such as the Convention on the Contract for the International Carriage of Goods by Road, 1956 ("CMR"),⁷ and the International Convention Concerning the Carriage of Goods by Rail, 1980 ("COTIF-CIM"),⁸ and its subsequent revisions (see A/CN.9/510, para. 30). It was further indicated that, while it would be desirable that the draft convention should resolve conflicts with non-maritime transport conventions of mandatory application, at the same time, the draft convention should not become a fully-fledged multimodal instrument (see A/CN.9/510, para. 28).

10. After an exhaustive exchange of views, the Working Group considered that, in light of the needs of worldwide trade and the requirements of modern international container carriage, it would be useful to continue its discussion of the draft convention under the provisional working assumption that it would cover door-to-door transport operations, and requested the Commission to approve that approach (see A/CN.9/510, para. 30).

11. In response to that request, at its thirty-fifth session (New York, 17-28 June 2002), the Commission approved the working assumption that the draft instrument should cover door-to-door transport operations, subject to further consideration of the scope of application of the draft instrument after the Working Group had considered the substantive provisions of the draft instrument and come to a more complete understanding of their functioning in a door-to-door context.⁹

12. The underlying reason for this decision was the particular importance of a door-to-door scope of application since a new instrument intended for global use must take into account the needs of worldwide trade and the requirements of modern international maritime container carriage. It was also recognized that modern carriage of goods often involves carriage under two or more means of transport to include pre- and post-maritime mode of transport. In fact, most existing unimodal inland transport conventions, including the CMR, had already recognized the need for some scheme to accommodate that commercial reality. In addition to article 2 of the CMR, reference may be had in this regard to article 1, paragraphs 3 and 4, and article 38 of the COTIF-CIM, as amended by the Protocol of Modification of 1999; article 2 of the Budapest Convention on the Contract for the Carriage of Goods by Inland Waterway, 2000 ("CMNI");¹⁰ article 18, paragraph 5, and article 31 of the Convention for the Unification of Certain Rules Relating to International Carriage by Air, 1929, as amended by the Protocol signed at The Hague on 28 September 1955 and by the Protocol No. 4 signed at Montreal on 25 September 1975 (the Warsaw Convention);¹¹ and articles 18, paragraph 4, and 38 of the Montreal Convention.

13. In opting for door-to-door coverage as a working assumption, the Working Group departed from the approach taken in the Hamburg Rules, which are limited to

⁷ United Nations, *Treaty Series*, vol. 399, No. 5742.

⁸ United Nations, *Treaty Series*, vol. 1397, No. 23353.

⁹ *Official Records of the General Assembly, Fifty-sixth Session, Supplement No. 17, (A/56/17)*, paragraph 224.

¹⁰ CMNI/CONF(99)2/FINAL-ECE/TRANS/CMNI/CONF/2/FINAL (treaty not yet in force).

¹¹ United Nations, *Treaty Series*, vol. 2145, No. 6943.

port-to-port carriage. At the same time, however, the Working Group agreed that the draft convention should not go so far as attempting to replace all unimodal transport regimes by a single multimodal system. Thus, the expanded scope of application of the draft convention does not affect the general policy of safeguarding the application of existing conventions that apply to contracts of carriage of goods primarily by a mode of transport other than sea carriage, as reflected in article 25, paragraph 5, of the Hamburg Rules.

A. The limited network approach to carrier's liability in door-to-door transportation

14. At its eleventh session (New York, 24 March-4 April 2003), the Working Group discussed how best to deal with the door-to-door carriage of goods (see A/CN.9/526, paras. 219-239; see also A/CN.9/WG.III/WP.29). It was indicated that, in principle, such carriage could be regulated under a "uniform system", under a "network system", or under a combination of the two. It was further explained that under a uniform system, the same rules would apply to the carriage, irrespective of the stage or mode of transportation when the loss, damage or delay occurred. It was also explained that under a network system, different rules relating to unimodal transport could apply depending upon the different stages or modes of transportation when the loss, damage or delay occurred, while a set of uniform rules would apply in the case of non-localized loss or damage.

15. It was suggested that the adoption of a network system would better serve the needs of the industry, given the importance of non-maritime legs in door-to-door carriage, especially for containerized traffic, as witnessed by the fact that the maritime transport industry had already developed contractual versions of limited network systems, with the widespread adoption of the UNCTAD/ICC Rules for Multimodal Transport Documents, 1992,¹² and of the BIMCO COMBICONBILL Combined Transport Bill of Lading, 1995¹³ (see A/CN.9/526, paras. 232 and 234).

16. However, support was also expressed for the adoption of a uniform liability system for door-to-door carriage of goods. It was suggested that a uniform liability system would best address the needs of door-to-door carriage, and was indeed the approach adopted in the United Nations Convention on International Multimodal Transport of Goods, 1980 ("Multimodal Convention").¹⁴ It was added that the adoption of a uniform liability regime would also be in line with the wishes of the trade to extend to maritime carriage the trend in favour of the extension of the scope of unimodal conventions to other modes of carriage preceding or subsequent to its own mode of carriage (see A/CN.9/526, para. 223).

17. The Working Group considered extensively the advantages and disadvantages of both the network and the uniform liability system for dealing with door-to-door carriage. The consensus that eventually emerged at the Working Group's twelfth session (Vienna, 6-17 October 2003) favoured the retention of a limited network system, as reflected in draft article 27 as set out in A/CN.9/WG.III/WP.56 (previously draft article 8 in A/CN.9/WG.III/WP.32; originally draft article 4.2.1 in A/CN.9/WG.III/WP.21) (see A/CN.9/544, paras. 20-27). Draft article 27 provides

¹² ICC publication, No. 481 (ICC, Paris, 1992).

¹³ *BIMCO Bulletin*, vol. 91, 1996.

¹⁴ TD/MT/CONF/16 (treaty not yet in force).

that, when the loss, damage or delay giving rise to the claim occurs during carriage preceding or subsequent to the sea carriage, provisions of an international convention that provide for carrier's liability, limitation of liability or time for suit should prevail over the provisions of the draft convention to the extent that such other convention declares itself applicable and its liability provisions are mandatory.

18. The network system in draft article 27, paragraph 1, is limited in a double sense. Firstly, the network system is limited to the issue of the carrier's liability. In all areas of the draft convention other than carrier's liability, limitation of liability and time for suit, the provisions of the draft convention would apply irrespective of any different provisions that may exist in other applicable conventions (A/CN.9/WG.III/WP.29, para. 72; see also paras. 73-105, for an analysis of the possible application of competing conventions on issues outside of carrier's liability, limitation of liability and time for suit). Secondly, the limited network system only comes into play in situations where, because of an expanded interpretation of the coverage of a given unimodal transport convention, there might be a conflict between the liability provisions of the draft convention and the liability provisions of the relevant unimodal transport convention.

19. The essence of such a limited network system, therefore, is that, in the event that both conventions are held applicable to a particular contract of carriage and damage to the goods occurred during a transport leg other than sea carriage, the relevant provisions mandatorily applicable to the determination of liability of the inland carrier "apply directly to the contractual relationship between the carrier on the one hand and the shipper or consignee on the other" (A/CN.9/WG.III/WP.29, para. 52). Thus, in respect of that relationship, the provisions of the draft instrument apply in conjunction with the provisions mandatorily applicable to the inland transport; whereas as between carrier and inland subcontracting carrier, the inland provisions alone are relevant (supplemented as necessary by any applicable national law) (A/CN.9/WG.III/WP.29, para. 52).

B. Scope of the network system in draft article 27

20. The limited network system contemplated in draft article 27 has given rise to some criticism by other organizations and scholars. In a letter addressed to the Secretariat, the International Road Transport Union (IRU) has expressed the view that, by adopting a limited network system, the draft convention would be in conflict with other international agreements, and contravene general treaty law.¹⁵ The IRU argues, *inter alia*, that draft article 27 would run counter to article 1, paragraph 5, of the CMR Convention, which prohibits modifications to the CMR Convention other than those allowed for in that convention, as well as article 41, paragraph 1, of the Vienna Convention on the Law of Treaties, which prohibits modification of a multilateral treaty between only some of its parties, except in certain circumstances. A similar objection to the network system had already been raised at the Working Group's eleventh session, when it was said that the current draft article 27, paragraph 1, "did not solve the issue of conflict of conventions, since it gave preference only to specific provisions of applicable unimodal conventions" (see A/CN.9/526, para. 246).

¹⁵ The text of the letter from the IRU, as well as the reply sent by the UNCITRAL secretariat, have been made available to the Contracting Parties of the CMR by the United Nations Economic Commission for Europe and can be found in www.unece.org/trans/main/sc1/sc1cmr.html.

21. Another line of criticism concerns the practical operation of the limited network system. It has been argued that draft article 27 might have the undesirable effect of derogating from inland treaties whose rules would have been better suited to regulate non-maritime carriage of goods than the rules contained in the draft convention. Furthermore, to the extent that draft article 27 only defers to other mandatory law as regards the carrier's "liability, limitation of liability or time for suit", it has been argued that the applicable rules would consist of "a combination of some provisions of the applicable unimodal regime, as interpreted by the relevant court or arbitral tribunal, together with the remaining part of the [draft convention]".¹⁶ This has been said to lead to an "obscure patchwork of different regimes which were not designed to complement each other", thus introducing elements of uncertainty on the law applicable to the contract of carriage.¹⁷ It has been further said that a clear-cut distinction between rules that "specifically provide for carrier's liability, limitation of liability or time for suit" and other mandatory rules in an international convention or domestic law governing carriage of goods by a particular mode of transportation is not always feasible. In view of the divergences that already exist in the interpretation of some existing unimodal conventions, provisions on jurisdiction in other conventions, for example, have been said to have a significant practical impact on the claimant's position, thus affecting the carrier's liability.¹⁸

22. In considering the first level of criticism, this note will leave aside the theoretical question as to whether and to what extent a subsequent provision in a treaty dealing with a subject matter not expressly dealt with in an earlier treaty concerned with a different legal relationship might be regarded as a modification of the earlier treaty under public international law. To the extent that the draft convention deals with a type of contract different from the contract governed, for instance, by the CMR, article 27, paragraph 1, should be seen as a provision that coordinates the application of the liability regime provided for in the draft convention vis-à-vis the liability regime provided for in other conventions, such as the CMR, and not as a modification of the liability rules of any other convention.

23. The scope of application of the draft convention and of existing unimodal transport conventions should normally be mutually exclusive (see A/CN.9/WG.III/WP.29, paras. 54-71). Accordingly, draft article 27, paragraph 1, would be expected to apply only to situations where some of those other conventions, "according to their terms", were to be interpreted as covering a contract of carriage involving a portion of carriage by a mode other than the mode primarily governed by the convention in question. Except for those cases where such an expanded interpretation of the scope of a given unimodal transport convention might lead that convention to be held applicable to a door-to-door carriage involving a sea leg to which the draft convention, in accordance with draft article 8, would also apply, no conflict should be expected between the draft convention and existing unimodal transport conventions.

¹⁶ See, for instance, Mahin Faghfour, "International regulation of liability for multimodal transport — in search of uniformity", *WMU journal of maritime affairs*, vol. 5, No. 1 (2006), pp. 95-114.

¹⁷ Comments by UNCTAD on the draft convention (A/CN.9/WG.III/WP.21/Add.1, Annex II, para. 44).

¹⁸ See, for instance, Krijn Haak and Marian Hoeks, "Intermodal transport under unimodal arrangements. Conflicting conventions: the UNCITRAL/CMI draft instrument and the CMR on the subject of intermodal contracts", *Transportrecht*, vol. 28, No. 3 (2005), pp. 89-102.

24. Furthermore, article 27 should be read in conjunction with other provisions that establish the scope of application of the draft convention. According to draft article 19, paragraph 1, the carrier is liable vis-à-vis the shipper and the consignee, for the acts and omissions of any performing parties and other persons that undertake to perform any of the carrier's obligations under the contract of carriage, in accordance with the liability rules of the draft convention. However, in the course of its deliberations, the Working Group has agreed to the proposition that only maritime performing parties (that is, generally those that would have been covered in a port-to-port instrument) will be covered by the draft instrument, and that non-maritime performing parties are excluded from the liability regime of the draft convention, even though vis-à-vis the shipper and the consignee the carrier remains liable for their acts (see A/CN.9/544, para. 23).

25. Therefore, a conflict of conventions could not arise under the draft convention with respect to recourse action of the door-to-door carrier against a non-maritime performing carrier (i.e. of the carrier against the subcontracting inland carrier), which remains governed by other applicable law outside the draft convention. This circumstance alone represents an important safeguard to limit the possible scope for conflict between the draft convention and other international conventions or domestic law that mandatorily applies to the liability of the carrier in other modes of transport. The Working Group agreed to make this point evident and adjust the scope of application of the draft convention (see A/CN.9/544, paras. 20-27). The notion of "maritime performing party" was accordingly inserted in the draft convention to limit direct actions under the draft convention to actions between the contractual parties to the maritime contract of carriage and to actions against the maritime performing party (see A/CN.9/544, paras. 28-42).

26. As regards the criticism concerning the practical operation of the limited network system contemplated in draft article 27, paragraph 1, it should be noted that the approach taken in draft article 27, paragraph 1, is not novel. Indeed, the widely-used Bimco COMBICONBILL reads, in relevant part, as follows:

"9. Basic Liability

"(1) The Carrier shall be liable for loss of or damage to the goods occurring between the time when he receives the goods into his charge and the time of delivery [...]."

"11. Special Provisions for Liability and Compensation

"(1) Notwithstanding anything provided for in Clauses 9 and 10 of this Bill of Lading, if it can be proved where the loss or damage occurred, the Carrier and the Merchant shall, as to the liability of the Carrier, be entitled to require such liability to be determined by the provisions contained in any international convention or national law, which provisions:

"(a) cannot be departed from by private contract, to the detriment of the claimant, and

"(b) would have applied if the Merchant had made a separate and direct contract with the Carrier in respect of the particular stage of transport where the loss or damage occurred and received as evidence thereof any particular document which must be issued if such international convention or national law shall apply.

“(2) Insofar as there is not mandatory law applying to carriage by sea by virtue of the provisions of sub-clause 11 (1), the liability of the Carrier in respect of any carriage by sea shall be determined by the [...] Hague-Visby Rules. The Hague-Visby Rules shall also determine the liability of the Carrier in respect of carriage by inland waterways as if such carriage were carriage by sea [...]”

27. Unlike draft article 27, paragraph 1, the COMBICONBILL does not specify which mandatory provisions of the relevant “international convention or national law” would apply instead of the Hague-Visby Rules. Nevertheless, the phrase “the Carrier and the Merchant shall, as to the liability of the Carrier, be entitled to require such liability to be determined by the provisions contained in any international convention or national law” makes it obvious that the “network system” contemplated by the COMBICONBILL is limited to provisions directly relevant to the determination of the carrier’s liability. Therefore, although the formulation of draft article 27, paragraph 1, differs from the relevant provisions in the COMBICONBILL, the practical operation of the limited network system, as contemplated in draft article 27, paragraph 1, is consistent with that industry standard.

28. The fact that draft article 27, paragraph 1, adopts a limited network system for the carrier’s liability does not create a conflict with the liability system in existing or future unimodal conventions. On the contrary, such a system may be said to offer a solution, in the context of the type of carriage covered by the draft convention, for a conflict that would likely arise in the absence of such a provision, since a judge or arbitrator would be otherwise left with no indication as to which rules should be applied to establish the carrier’s liability in case of localized loss or damage. The choice made in draft article 27, paragraph 1, gives full effect to those provisions of other conventions that specifically provide for carrier’s liability, limitation of liability or time for suit that mandatorily apply. The reference to provisions that “specifically provide for the carrier’s liability, limitation of liability or time for suit” is a logical corollary to the context of the provision, which is concerned with the determination of the carrier’s liability. Provisions that in a concrete case would have no bearing on the determination of the carrier’s liability should not displace the relevant provisions of the draft convention. As currently worded, the provision would seem to be sufficiently broad to leave it for the prudent discretion of the courts or arbitrators to decide which of the mandatory provisions in other conventions “specifically provide” for the carrier’s liability, limitation of liability or time for suit, and should thus prevail over the draft convention.

29. However, should the Working Group consider that, for the avoidance of doubt, further clarification in this regard would still be desirable, the Working Group may wish to consider that it would be desirable to spell out clearly one of the basic elements of the compromise arrived at by the Working Group at its twelfth session, that, where the provisions in the draft convention “relate to the obligations and liability of performing parties, reference should be made only to maritime performing parties” and that the draft convention should be revised “to create a direct cause of action against maritime performing parties only” (see A/CN.9/544, para. 21). In that case, the Working Group may wish to consider inserting, at an appropriate place, a provision along the following lines:

“This Convention does not establish a direct cause of action by the shipper, the consignee, or any other person against [any person other than a carrier or a maritime performing party] [a non-maritime performing party].”

30. It is submitted that the addition of a provision that expressly limits direct actions under the draft convention to actions between the contractual parties to the maritime contract of carriage and to actions against the maritime performing party (thus preserving the application of other mandatory law, if any, to the relations between the carrier and the non-maritime performing parties) might address remaining concerns about the potential conflicts with other conventions that have been identified earlier (see A/CN.9/WG.III/WP.29, paras. 72-110).

31. Notwithstanding the above considerations, should the Working Group not be convinced that this would suffice to avoid conflicts with the liability regime in other conventions, two alternative options might be considered. One option might be to expand draft article 27, paragraph 1, beyond the matters referred to therein so as to encompass, for example, other matters, such as shipper's obligations, as has been suggested earlier (see, for example, A/CN.9/WG.III/WP.29, para. 84). Another alternative available would be for the Working Group to change the limited network system under draft article 27 into an "unlimited" network system, thus allowing for the application of all relevant mandatory provisions of unimodal transport conventions where those conventions would be applicable. Such an alternative, however, would require a revision of the policy direction earlier taken by the Working Group in favour of a limited network system, which in the view of the Working Group would promote greater uniformity than an unlimited one (see A/CN.9/544, paras. 23, 24 and 47).

C. Treatment of non-localized loss or damage

32. The draft convention complements the limited network system for localized damage with a uniform system for the case of non-localized loss or damage. Indeed, draft article 27, paragraph 2, refers to draft article 64, paragraph 2, which provides that, in case of non-localized loss or damage, the highest limit of liability found in the various international instruments that could govern the different legs of the transport should apply.

33. Draft article 64, paragraph 2, was inserted following a request made at the Working Group's eleventh session. At that time, the view was expressed that the liability limits set out in the Hague-Visby Rules were too low to be acceptable as a default rule in case of non-localized damage, and that higher limits of liability should apply in case of non-localized damage. It was also suggested that the draft instrument should be amended to reflect the policy that, should the carrier wish to avoid the higher limit of liability, it should bear the burden of proving in which leg of the carriage the damage had occurred (see A/CN.9/526, para. 264). The Working Group discussed draft article 64, paragraph 2, at its twelfth session, when it was decided to keep the provision in square brackets, pending the decision of the Working Group on the liability limit set forth in draft article 64, paragraph 1 (see A/CN.9/544, paras. 43-50).

34. At the time draft article 64, paragraph 2, was proposed, it was questioned why the draft instrument should apply as a default rule in case of non-localized damage. In response, the view was reiterated that the main consideration regarding that matter should be to ensure predictability and certainty regarding the liability regime applicable to non-localized damage (see A/CN.9/526, para. 262). This conclusion flows logically from the very wording of draft article 27, which was conceived as an exception to the overall regime of the draft convention. It is implicit in the liability

system established by the draft convention that in cases where it cannot be established that loss of or damage to goods or delay occurred “before the time of their loading on to the ship” or “after their discharge from the ship to the time of their delivery to the consignee” (i.e. if the damage is not “localized”), the regime of the draft convention will apply.

35. The Working Group might wish to note that, under a uniform system for non-localized damage, a conflict with unimodal transport conventions of mandatory application might arise, in theory, in cases where (a) any such convention were to be interpreted so as to cover a contract that included carriage by modes other than the mode primarily governed by that convention; and (b) one could argue that the liability provisions of such convention could apply even if it was not proved that the damage occurred during carriage by the mode specifically covered by the convention in question (i.e. non-localized damage). If the liability rules of the draft convention and of such competing unimodal convention differed, an action might lead to different outcomes depending under which convention it was brought. In practice, however, it is suggested that such a conflict would be unlikely to arise in view of the fact that the draft convention effectively limits direct actions under the draft convention to actions between the contractual parties to the maritime contract of carriage and to actions against the maritime performing party. As the shipper, consignee or other interested party would not be privy to a subcontract of carriage by a mode other than sea carriage that might be covered by other conventions, the shipper, consignee or other interested party would not normally be entitled to sue the subcontracting carrier directly under the draft convention.

36. In any event, the Working Group may find it desirable to coordinate more clearly the legal regimes governing localized damage under article 27, paragraph 1 and non-localized damage under article 64, paragraph 2, as has been suggested earlier (see A/CN.9/526, para. 266). Such a clarification might be useful even if draft article 64, paragraph 2, were not retained in the draft convention, as it would clarify the exceptional nature of the limited network system under article 27 and clearly spell out the fact that the draft convention would introduce a uniform liability system for door-to-door carriage, which even opponents of the limited network system have said to be one of the main contributions that the draft convention might offer.¹⁹ A possible clarifying provision might read along the following lines:

“Except where otherwise provided in [article 27, paragraph 1 and 64, paragraph 2], the liability of the carrier and the maritime performing party for loss of or damage to the goods, or for delay, shall be solely governed by the provisions of this Convention.”

¹⁹ “If the network system in the draft were to be expanded as suggested however, the draft instrument could do a lot of good in the field of intermodal transport. It would create more uniformity in the area of international sea carriage law, and it would fill up some holes concerning for example the liability in case of unlocalized loss under multimodal contracts by virtue of a complementary effect to existing unimodal conventions” (Krijn Haak and Marian Hoeks, *op. cit.*, p. 102).

D. Other instances of possible derogation from mandatory regimes of non-maritime transport conventions

37. The combined effect of draft article 27, paragraph 1, with the implicit uniform system for the carrier's liability in respect of non-localized damage is that, at least as regards the determination of the carrier's liability, the applicable rules are generally clear: if the damage is localized, the provisions that specifically provide for carrier's liability, limitation of liability, or time for suit of other conventions of mandatory application shall apply; if the damage is not localized, the draft convention applies. Obviously, the question as to how much of the other convention needs to be preserved to govern the carrier's liability for localized damage still needs to be further considered by the Working Group. As a matter of principle, however, the rules offer a workable solution for determining the carrier's liability. Combined with the limitation of actions under the draft convention only to actions against the carrier and the maritime performing party, the overall features of this system may avoid conflicts of liability regimes. It is submitted that the draft convention therefore already offers a workable means for dealing with what, in practice, is likely to be the main source of private disputes arising out of a contract of carriage under the draft convention (i.e. the carrier's liability for cargo loss or damage, or for delay).

38. However, as indicated above (see above, para. 18), the draft convention currently does not provide a system to avoid conflicts with other conventions in respect of matters other than the carrier's liability that may be governed by those conventions. Possible areas where the provisions of the draft convention may differ from those contained in some other conventions governing carriage by other modes of transportation have been identified earlier, and include certain aspects of matters such as obligations and liability of the shipper for damage caused by the goods; obligations of the shipper to furnish information; transport documents; right of control; delivery of the goods and transfer of rights (see A/CN.9/WG.III/WP.29, paras. 72-105).

39. It is assumed that the scope of conflict is already reduced by the way the draft convention circumscribes its scope of application. As stated in the reply by the UNCITRAL Secretariat to the IRU letter (see above, para. 20), the draft convention and the CMR are by the very terms of their scope of application intended to apply to different contracts of carriage:

“... the draft convention carefully limits its application to the master maritime contract of carriage under which the carrier undertakes to carry goods from one place to another and which must provide for international carriage by sea, while the CMR applies to international contracts of carriage by road, including to any subcontracts for international road carriage that may exist under the master maritime contract. The application of these two instruments is thus intended to be mutually exclusive.”

40. These considerations may apply, *mutatis mutandis*, to carriage by other modes of transportation. However, as indicated earlier (see A/CN.9/WG.III/WP.29, paras. 115-116), this conclusion presupposes that the scope of application of conventions dealing with carriage of goods by other modes of transportation would not be interpreted in a manner that would lead those conventions to apply to the type of carriage that the draft convention is intended to cover.

41. Of course, it is not possible for the draft convention to dictate how the scope of application of other conventions must be read. While the possibility of some overlap between the draft convention and other conventions may not be entirely excluded, it is submitted that the likelihood of residual conflict has already been greatly reduced by the combined effect of the provisions on the coordination of liability regimes for both localized and non-localized damage and by the definition of the scope of application of the draft convention (draft art. 1, subpara. (a), in conjunction with and draft art. 8).

E. Relation between draft article 89 and draft article 90

42. At the Working Group's eleventh session, the Secretariat was requested to draft a conflict of conventions provision for possible insertion into the text of the draft convention should it be necessary in addition to draft article 27 to resolve conflicts with other transport conventions (see A/CN.9/526, para. 250). This request was made after the Working Group had heard concerns that current draft article 27, paragraph 1, might not solve the issue of conflict of conventions, since it gave preference only to specific provisions of applicable unimodal transport conventions. At that time, it was also said that certain States would find it impossible to be signatory to more than one multimodal convention, and that if the draft instrument was a multimodal instrument, ratification of it could preclude some States from ratifying broader multimodal conventions. A further concern was that States parties to other instruments that have multimodal aspects, such as the Montreal Convention and COTIF, might have to denounce those conventions in favour of the draft instrument (A/CN.9/526, para. 246). Further to that request, draft article 89, which is based on article 25, paragraph 5, of the Hamburg Rules, was provisionally inserted in the draft text to provide that the draft convention would not displace the application of other international instruments already in force at the date of the conclusion of the draft convention and which would apply mandatorily to contracts of carriage of goods by a mode of transport other than carriage by sea.

43. At the same session, the Secretariat was also requested, in connection with the discussion of what was then draft article 16.1 (in A/CN.9/WG.III/WP.21), and is currently draft article 91 (in A/CN.9/WG.III/WP.56), to clarify the prevalence of the draft convention over earlier transport treaties incompatible with the draft convention (see A/CN.9/526, para. 196). Thus, draft article 90, indicating the prevalence of the draft convention over other treaties to which the parties to the draft convention might also be a party, was inserted in the draft convention. It was further clarified that, in line with article 30, paragraph 4, of the Vienna Convention on the Law of Treaties, the provision would not affect those States which would not become a party to the draft convention (see A/CN.9/WG.III/WP.32, footnote 232).

44. When taken outside the context from which they originate, draft article 89 and draft article 90 seem to reflect two opposite approaches to dealing with conflict of conventions so that the joint operation of the two draft articles, as currently worded, would not appear to be possible.

45. Draft article 89 preserves the application of unimodal transport conventions of mandatory application. This provision may be understood as complementary to the adoption in the draft convention (and, in particular, in its draft article 27, para. 1) of a limited network system to deal with liability in door-to-door transportation. Draft article 89 could indeed be read to mean that the limited precedence given by

draft article 27, paragraph 1, to mandatory liability provisions of other transport conventions in the relations between the carrier and the shipper or the consignee does not otherwise affect the operation of any other transport convention that may mandatorily apply to the relations between the carrier and a non-maritime performing party. However, draft article 89 might also be read as conflicting with draft article 27, paragraph 1, by giving general precedence over the draft convention to other transport conventions in respect of matters other than liability (to which draft art. 27, para. 1, already refers), even in the relations between the carrier and the shipper or consignee, and not only in the relations between the carrier and the subcontractor whose activities would usually fall under the scope of the other transport convention.

46. Draft article 90, in turn, indicates the prevalence of the draft convention over all other conventions incompatible with its provisions, including those relating to non-maritime carriage of goods. It seems that draft article 90 is intended to facilitate the general adoption of a uniform system to deal with liability in door-to-door transportation. In its current formulation, however, and when read in isolation, draft article 90 might also be interpreted as a general clause relating to the prevalence of the draft convention over all treaties that might contain provisions incompatible with the draft convention.

47. In the light of the above, the Working Group may wish to reconsider both articles 89 and 90 in light of the provisions and policy options to which they are logically related.

48. The arguments that prompted the inclusion of draft article 89 show some similarity to the arguments voiced in favour of the inclusion of article 25, paragraph 5, of the Hamburg Rules during the United Nations Conference on the Carriage of Goods by Sea (Hamburg, 6-31 March 1978). Article 25, paragraph 5, was added to the Hamburg Rules following the adoption of the final definition of “contract of carriage by sea”, in article 1, paragraph 6, of the Hamburg Rules, which provides that “a contract which involves carriage by sea and also carriage by some other means is deemed to be a contract of carriage by sea for the purposes of this Convention only in so far as it relates to the carriage by sea”. At that time, it was said, that this slightly expanded notion of “contract of carriage” made it necessary to include a provision that preserved the application of other conventions that might cover transport by more than one mode because the Hamburg Rules could not solve “the general problem of the international regulation of multimodal transport”, as it lacked “provision for cases in which the place where damage had occurred was unknown” as well as “uniform rules to regulate certain procedural matters”.²⁰ Indeed it appears that most supporters of the inclusion of article 25, paragraph 5, of the Hamburg Rules were concerned with the fact of bringing carriage primarily conducted through means other than sea carriage under the umbrella of a convention that only applied to the sea-borne part of multimodal transport.²¹

49. The Working Group may wish to note the substantive differences between the Hamburg Rules, where the responsibility of the carrier only covers the period

²⁰ *Official Records of the United Nations Conference of the Carriage of Goods by Sea (Hamburg, 6-31 March 1978)* (United Nations publication, sales No. E.80.VIII.1), part II, Summary records of meetings of the Second Committee, 7th meeting (A/CONF.89/C.2/SR.7), paragraph 50; see also *ibid.*, 9th meeting (A/CONF.89/C.2/SR.9), paragraph 9.

²¹ *Ibid.*, 7th meeting (A/CONF.89/C.2/SR.7), paragraphs 39-62; 8th meeting (A/CONF.89/C.2/SR.8), paragraphs 4-30; 9th meeting (A/CONF.89/C.2/SR.9), paragraphs 2-34.

“during which the carrier is in charge of the goods at the port of loading, during the carriage and at the port of discharge”, and the draft convention, which may extend “door-to-door”. Furthermore, unlike the Hamburg Rules, the draft convention expressly provides for the legal regime that should govern the carrier’s liability for localized damage under multimodal transportation and extends otherwise its own liability regime for all cases where damage has not been localized. In the context of the Hamburg Rules, article 25, paragraph 5, served the purpose of dispelling possible concerns that the inland leg of a multimodal transportation under a contract of carriage to which the Hamburg Rules applied might be left in a legal vacuum. The Working Group may wish to consider that the context of the draft convention is quite different from the Hamburg Rules and that, accordingly, there might not be the same need for a provision along the lines of draft article 89, at least in the same formulation as in the Hamburg Rules.

50. Moreover, if the Working Group were to conclude that the intended purpose of draft article 89 was to complement the limited network system under draft article 27, paragraph 1, the Working Group might wish to consider that the provision, which was proposed before the adjustments made to the treatment of performing parties (see above, paras. 24 and 25) may not be needed. Indeed, the entire liability system of the draft convention is now limited to the carrier and the maritime performing party, and the draft convention is not concerned with the legal regime governing any subcontracts that may be entered into by the carrier for transportation other than sea carriage. The Working Group may wish to consider that it is not appropriate for the draft convention, which clearly defines its own scope of application, to venture into what law, pursuant to its own terms, should apply to the relations between the carrier and a non-maritime performing party. In any event, if the Working Group still felt a need for draft article 89, it would seem advisable to clarify the relationship between draft article 89 and draft article 27, paragraph 1.

51. On the other hand, if the Working Group were to conclude that the intended purpose of draft article 89 is to give general precedence to other transport conventions also in respect of matters other than liability (for which there is a specific rule in draft art. 27, para. 1), the Working Group might wish to consider that draft article 89 is incompatible with the limited nature of the network system provided for in draft article 27, paragraph 1.

52. Similarly, as regards draft article 90, if the Working Group were to conclude that the rationale for this provision was originally to offer a complementary solution for conflicts of diverging liability regimes in international conventions, the Working Group may wish to consider that this provision, too, is not needed, and would in any event conflict with draft article 89, if that provision is retained. Indeed, draft article 90 was inserted at a time when the draft convention did not explicitly limit direct actions under the draft convention to actions between the contractual parties to the overarching maritime contract of carriage, and may have become obsolete since the types of conflicts that draft article 90 was intended to settle might in the meantime have been avoided by the refined scope of application of the draft convention, following the Working Group’s almost unanimous support for the exclusion of non-maritime performing parties from the liability regime of the draft instrument (see A/CN.9/544, paras. 20-27).

53. Should the Working Group, in turn, regard draft article 90 as a general rule aimed at solving possible residual conflicts with other conventions in areas other than the liability of the carrier (see above, para. 38), the Working Group may still

wish to consider whether the range of possible conflict situations that this draft article would be intended to solve would justify the inclusion of such a far-reaching provision. The Working Group may wish to note that clauses of general prevalence are not common in international trade law treaties. They are in fact more frequent in other instruments, especially those that establish international intergovernmental organizations (see, for instance, art. 103 of the Charter of the United Nations).

IV. Relation between the draft convention and other international legal instruments

54. Draft article 16 of the draft convention in A/CN.9/WG.III/WP.21 contained a draft provision on the relation of the draft convention with conventions relating to: limitation of liability relating to the operation of vessels; carriage of passengers and their luggage by sea; and damage caused by nuclear incidents. Those provisions, whose content was inspired by article 25, paragraphs 1, 3 and 4, of the Hamburg Rules, are currently draft articles 91, 92 and 93 of the draft convention.

55. The Working Group may wish to consider that these provisions, by affirming the continued application of those other conventions, adequately avoid possible conflicts between them and the draft convention.

**I. Note by the Secretariat on the preparation of a draft convention
on the carriage of goods [wholly or partly] [by sea] — Identity of
carrier — Drafting proposal by the Governments of Italy and
the Netherlands, submitted to the Working Group on
Transport Law at its eighteenth session
(A/CN.9/WG.III/WP.79) [Original: English]**

In preparation for the eighteenth session of Working Group III (Transport Law), the Governments of Italy and the Netherlands submitted to the Secretariat the proposal attached hereto as an annex with respect to the identity of carrier in the draft convention on the carriage of goods [wholly or partly] [by sea].

The document in the attached annex is reproduced in the form in which it was received by the Secretariat.

ANNEX

Identity of carrier

1. This proposal is intended to address practical problems relating to transport documents that are unclear as to the identity of the carrier. It tries to take into account the observations made by delegates when draft article 40 (3) was discussed previously.¹

2. The premises of the proposal are that the evidentiary function of a transport document entails that any holder of the document must be able to ascertain from the document itself who the carrier is. In principle, research into the contractual relations between the shipper and the carrier should not be needed in order to find out who the carrier is.

3. The first practical problem addressed in this proposal is the matter of an unclear face of the document. Such face may include certain names that legally may be the carrier's booking agents or its trade name only. However, it is important that the carrier is *identified* as such on the document.² Therefore, it is proposed that article 38 (e) is redrafted as follows:

“(e) the name and address of a person identified as carrier;”

4. A second practical problem is that the carrier is identified on the face of the document (often in the signature box), while the small print at the reverse of the same document includes a clause on the identity of carrier or a demise clause that refers to the owner of the carrying vessel as the carrier. Often, these two indications of the carrier's identity are in conflict. The ambiguity resulting therefrom may be solved by making the information on the face of the document to prevail over the

¹ See A/CN.9/526, paras. 56-60 and A/CN.9/WG.III/WP.62, paras. 27-34.

² This is in line with the requirements of articles 23 (a)(i) and 26 (a)(i) of the ICC Uniform Customs and Practice for Documentary Credits 500 (UCP 500). However, these articles also accept bills of lading signed by the master of the carrying vessel without the carrier being identified.

information at the reverse side. For this purpose the following language is suggested:

“If a person is on the face of a transport document or electronic record identified as the carrier, any information on the reverse side of the transport document or electronic record expressly or impliedly identifying a different person as the carrier shall have no legal effect.”

5. Thirdly, from the document it may not be sufficiently clear who the carrier is. At present, many transport documents do not comply with the requirement of draft article 38 (e). The most common example is the document signed by (or on behalf of) the master. In such case it is rarely stated whether the master has signed pursuant to the authority of the owner of the vessel or the authority of somebody else, such as a time- or voyage charterer. Under many national jurisdictions case law has developed dealing with this matter and some jurisdictions may have statutory provisions too. However, these solutions at national level are far from uniform. To address this issue, the current draft article 40 (3) introduces a rebuttable presumption that the registered owner is the carrier. However, in previous discussions this draft provision gave rise to several critical questions. Therefore, hereunder is a new and more refined draft suggested as a replacement of the current draft of article 40 (3) that may address most of the concerns raised:

“If no person is identified in the transport document or electronic record as the carrier or its name and address is not included therein, but the contract particulars indicate that the goods have been loaded on board of a named ship, then the registered owner of that ship is presumed to be the carrier, unless it proves that the ship was under a bareboat charter at the time of the carriage and it identifies this bareboat charterer and indicate its address, in which case this bareboat charterer is presumed to be the carrier.

Alternatively, the owner may defeat the presumption of being the carrier by identifying the carrier and indicating its address. The bareboat charterer may defeat any presumption of being the carrier in the same manner.”

6. If the draft proposed in the previous paragraph would be accepted, a consequential provision is needed to the effect that the one year prescription period must be extended for cases that the presumption is rebutted. A draft could be:

“If the owner has identified the bareboat charterer and has provided its address, or any of them has identified the carrier and provided its address, the period mentioned in article 69 shall not run from the date of institution of judicial or arbitral proceedings against the registered owner or bareboat charterer until the lapse of 90 days from the date when the relevant information is provided by the owner or the bareboat charterer as the case may be.”

7. Finally, as a drafting matter it is suggested to the secretariat to delete the current draft article 40 (3) and, instead, to create a new article to be placed between the current articles 38 and 39 that, if adopted, includes the drafts outlined in the paragraphs 4, 5 and 6 above. Such new article may bear the heading:

“Identity of carrier”

**J. Report of the Working Group on Transport Law on the work of
its nineteenth session (New York, 16-27 April 2007)**

(A/CN.9/621) [Original: English]

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Introduction

1. At its thirty-fourth session, in 2001, the Commission established Working Group III (Transport Law) and entrusted it with the task of preparing, in close cooperation with interested international organizations, a legislative instrument on issues relating to the international carriage of goods such as the scope of application, the period of responsibility of the carrier, obligations of the carrier, liability of the carrier, obligations of the shipper and transport documents.¹ The Working Group commenced its deliberations on a draft convention on the carriage of goods [wholly or partly] [by sea] at its ninth session in 2002. The most recent compilation of historical references regarding the legislative history of the draft convention can be found in document A/CN.9/WG.III/WP.80.

2. Working Group III (Transport Law), which was composed of all States members of the Commission, held its nineteenth session in New York from 16 to 27 April 2007. The session was attended by representatives of the following States members of the Working Group: Algeria, Argentina, Australia, Austria, Belarus, Benin, Brazil, Cameroon, Canada, Chile, China, Colombia, Czech Republic, Ecuador, France, Gabon, Germany, Guatemala, India, Iran (Islamic Republic of), Italy, Japan, Kenya, Lebanon, Mexico, Morocco, Nigeria, Pakistan, Republic of Korea, Russian Federation, Singapore, South Africa, Spain, Sweden, Switzerland, Thailand, Tunisia, Turkey, Uganda, United States of America, Venezuela (Bolivarian Republic of) and Zimbabwe.

3. The session was also attended by observers from the following States: Burkina Faso, Burundi, Congo, Costa Rica, Côte d'Ivoire, Cyprus, Democratic Republic of the Congo, Denmark, Dominican Republic, El Salvador, Finland, Ghana, Greece, Holy See, Indonesia, Kuwait, Latvia, Lesotho, Malaysia, the Republic of Moldova, Netherlands, New Zealand, Niger, Norway, Panama, Peru, Philippines, Romania, Saudi Arabia, Senegal, Ukraine and Yemen.

4. The session was also attended by observers from the following international organizations:

(a) **Intergovernmental organizations:** Asian-African Legal Consultative Organization, European Commission;

(b) **International non-governmental organizations invited by the Working Group:** Association of American Railroads (AAR), BIMCO, Comité Maritime International (CMI), European Shippers' Council (ESC), Ibero-American Institute of Maritime Law (IAIML), International Chamber of Commerce (ICC), International Chamber of Shipping (ICS), International Federation of Freight Forwarders Associations (FIATA), International Group of Protection and Indemnity (P&I) Clubs, International Multimodal Transport Association (IMMTA), International Union of Marine Insurance (IUMI), Maritime Organization of West and Central Africa (MOWCA), The European Law Students' Association International (ELSA), and the World Maritime University (WMU).

¹ *Official Records of the General Assembly, Fifty-sixth Session, Supplement No. 17 and corrigendum (A/56/17 and Corr.3)*, para. 345.

5. The Working Group elected the following officers:
Chairman: Mr. Rafael Illescas (Spain)
Rapporteur: Mr. Walter de Sá Leitão (Brazil)
6. The Working Group had before it the following documents:
 - (a) Annotated provisional agenda and corrigendum (A/CN.9/WG.III/WP.80 and A/CN.9/WG.III/WP.80/Corr.1);
 - (b) The draft convention on the carriage of goods [wholly or partly] [by sea] and corrigendum (A/CN.9/WG.III/WP.81 and A/CN.9/WG.III/WP.81/Corr.1);
 - (c) A document outlining the position of the French National Committee of the International Chamber of Commerce (ICC France) (A/CN.9/WG.III/WP.82);
 - (d) A document describing the position of the European Shippers' Council (A/CN.9/WG.III/WP.83);
 - (e) A proposal of the Government of the United States of America on the definition of "maritime performing party" (A/CN.9/WG.III/WP.84);
 - (f) A drafting proposal by the Government of Sweden on shipper's obligations (A/CN.9/WG.III/WP.85);
 - (g) A proposal of the governments of Denmark, Norway and Finland on draft article 37 (1)(a) regarding contract particulars (A/CN.9/WG.III/WP.86);
 - (h) A document containing comments of the International Chamber of Shipping (ICS), BIMCO and the International Group of P&I Clubs on the draft convention (A/CN.9/WG.III/WP.87);
 - (i) A joint proposal of the governments of Australia and France concerning volume contracts (A/CN.9/WG.III/WP.88);
 - (j) A document containing proposals of the Government of France regarding the linkage between the draft convention on the carriage of goods wholly or partly by sea and the conventions applicable to land or air transport (A/CN.9/WG.III/WP.89);
 - (k) Proposals by the International Road Transport Union (IRU) concerning articles 1 (7), 26 and 90 of the draft convention (A/CN.9/WG.III/WP.90);
 - (l) A proposal of the Government of the United States of America on carrier and shipper delay (A/CN.9/WG.III/WP.91); and
 - (m) A joint proposal by Australia and France on freedom of contract under volume contracts (A/CN.9/612).
7. The Working Group adopted the following agenda:
 1. Election of officers.
 2. Adoption of the agenda.
 3. Preparation of a draft convention on the carriage of goods [wholly or partly] [by sea].
 4. Other business.
 5. Adoption of the report.

I. Deliberations and decisions

8. The Working Group continued its review of the draft convention on the carriage of goods [wholly or partly] [by sea] (“the draft convention”) on the basis of the text contained in the annex to a note by the Secretariat (A/CN.9/WG.III/WP.81). The Working Group was reminded that the text contained in that note was the result of negotiations within the Working Group since 2002. The Working Group agreed that while the provisions of the draft convention could be further refined and clarified, to the extent that they reflected consensus already reached by the Working Group, the policy choices should only be revisited if there was a strong consensus to do so. Those deliberations and conclusions are reflected in section II below (see paras. 9 to 304 below). Note that all references to A/CN.9/WG.III/WP.81 in the following paragraphs are intended to indicate A/CN.9/WG.III/WP.81, as corrected by A/CN.9/WG.III/WP.81/Corr.1.

II. Preparation of a draft instrument on the carriage of goods [wholly or partly] [by sea]

Chapter 1. General provisions

Draft article 1. Definitions

9. The Working Group agreed to defer its discussions of article 1 until agreement had been reached on the substantive articles relating to the terms defined in draft article 1.

Draft article 2. Interpretation of this Convention

10. The Working Group recalled that the text contained in draft article 2 corresponded to that contained in A/CN.9/WG.III/WP.56. Noting that the text represented standard text in many international conventions, the Working Group approved the substance of the text contained in draft article 2.

Draft article 3. Form requirements

11. The Working Group considered the text in draft article 3 to be acceptable pending further examination as to the cross-references contained therein. The Working Group also agreed that it might be desirable to include within the final text an explanatory note to the effect that any notices contemplated in the draft convention that were not expressly mentioned in draft article 3 might be made by any means including orally or by exchange of data messages that did not meet the definition of “electronic communication”.

Draft article 4. Applicability of defences and limits of liability

12. Noting that draft article 4 referred to “maritime performing party”, it was agreed that discussion of the term be deferred until draft articles 18 and 19, which dealt generally with performing parties, were considered.

13. It was questioned whether there was a need to include draft article 4 given that draft article 5 already set out the scope of application of the draft convention. It was suggested that in many jurisdictions, courts might extend the defences and limits of

liability provided by the draft convention to other parties acting on behalf of the carrier even without a provision such as draft article 4. In response, it was noted that the provision was useful in certain jurisdictions. It was further pointed out that the draft article corresponded to similar provisions contained in the Hague-Visby and Hamburg Rules. It was said that its deletion might be interpreted as a reversal of the rule contained in those earlier conventions.

14. Support was expressed for the structure and underlying policy of draft article 4 but it was noted that, as currently drafted, the draft article appeared to apply only in respect of actions against the carrier. It was suggested that draft article 4 be extended to apply to shippers insofar as shipper liability was covered by the draft convention. That proposal received support.

15. Secondly, a concern was expressed that, as drafted, draft article 4 referred only to “defences and limits of liability” which might be too narrow and fail to protect the right of the carrier to a proper forum under the draft convention. It was suggested that draft article 4 be reviewed to ensure that it had the same intended effect in all jurisdictions.

16. A question was raised as to the meaning of the term “or otherwise”. It was suggested that those words were helpful to encompass claims other than contractual or tort claims such as claims in restitution or arising out of quasi-contract. It was agreed that the term should be retained to ensure that the draft article was broad enough to cover situations that might arise in different legal systems.

17. The Working Group adopted the definitions contained in paragraphs (5), (9) and (25) of draft article 1 in substance. Although it was deemed unnecessary in some legal systems, the Working Group agreed to retain draft article 4 and to extend its coverage to apply also to shippers to the extent that shipper liability was covered by the draft convention. In respect of the phrase, “or otherwise” the Working Group agreed to retain this phrase and requested the Secretariat to review its utility. In respect of procedural issues, the Working Group agreed that a review be undertaken as to the scope of defences and limits of liability after these terms had been settled.

Chapter 2. Scope of application

Draft article 5. General scope of application

18. The Working Group noted that draft article 5 corresponded to the text contained in draft article 8 of the text contained in A/CN.9/WG.III/WP.56. The Working Group approved the definition of the term “contract of carriage” as contained in draft article 1, paragraph (1). The Working Group also approved the text contained in draft article 5 as set out in A/CN.9/WG.III/WP.81.

Draft article 6. Specific exclusions

19. The Working Group noted that draft article 6 corresponded to draft article 9 of A/CN.9/WG.III/WP.56. A suggestion was made that as charterparties were not part of regularly scheduled transport, paragraph (1)(a) should be deleted and instead a reference should be made to wording such as “contract for the use of space on a vessel”.

20. It was noted that draft article 6 represented a compromise text and caution was expressed about reopening matters settled in that provision. It was noted that, in

general, there was a distinction between liner transportation and charterparties but that charterparties were occasionally used in liner carriage and thus the draft convention should address these new developments. As well, it was recalled that the Working Group had previously agreed that the coverage under the new convention should be at least as broad as what was already covered under the Hague and Hague-Visby Rules, which also applied to contracts of carriage under bills of lading in non-liner transportation.

21. For purposes of clarification, a number of drafting proposals were made. It was proposed to delete the term “contracts” in subparagraph (1)(b) of draft article 6 and replace it with “other contractual arrangements” and to delete the term “contract” in subparagraph (2)(a) of draft article 6 and replace it with “other contractual arrangement between the parties”. As well it was proposed that the words after “thereon”, namely “between the parties, whether such contract is a charterparty or not” be deleted. While there was support for these proposals, the Working Group agreed that the Secretariat should first ascertain whether they in fact merely clarified and did not have substantive effect on the scope of draft article 6. The Working Group accepted the provision, subject to drafting clarification.

Draft article 7. Application to certain parties

22. A question was raised as to whether the reference to consignors in draft article 7 was appropriate as it gave the impression that the draft convention regulated the relationship between the carrier and consignor. Even though it was agreed that the draft convention did not regulate the relationship between the carrier and consignor in all cases, the Working Group noted that the draft convention did regulate that relationship in some specific cases and therefore, it was important to mention the consignor in article 7. It was suggested that the draft article should be reviewed and possibly a cross reference to draft article 79 should be included to ensure that draft article 7 did not impact adversely on any arbitration agreement contained in a bill of lading held by a third party. That proposal was supported. The Working Group accepted the provision, subject to any necessary cross-reference.

Chapter 3. Electronic transport records

23. The Working Group was reminded that its most recent consideration of draft chapter 3 on electronic transport records was at its fifteenth session (see A/CN.9/576, paras. 180 to 210). The consideration by the Working Group of the provisions of chapter 3 was based on the text as found in A/CN.9/WG.III/WP.81.

Draft article 1 definitions relevant to chapter 3

24. The Working Group considered the text of the definitions in draft article 1 that were thought to be closely connected to the text of chapter 3: paragraph 16 on “transport document”; paragraph 17 on “negotiable transport document”; paragraph 18 on “non-negotiable transport document”; paragraph 20 on “electronic transport record”; paragraph 21 on “negotiable electronic transport record”; paragraph 22 on “non-negotiable electronic transport record”; and paragraph 23 on the “issuance” and “transfer” of a negotiable electronic transport record. It was recalled by the Working Group that those definitions had been the result of expert consultations with Working Group IV on electronic commerce, and that, along with the entire chapter, those provisions were considered to be both carefully drafted and

of a very technical nature. A view was expressed that the definition of “non-negotiable transport document” as found in draft article 1 (18) could possibly be deleted as redundant, but a preference was articulated for retaining the provision in order to maintain the goal of having an electronic equivalent for any paper document in the draft convention.

Conclusions reached by the Working Group regarding draft article 1 definitions relevant to chapter 3

25. The Working Group was in agreement that the definitions in draft article 1 set out in the paragraph above were acceptable as found in A/CN.9/WG.III/WP.81.

Draft article 8. Use and effect of electronic transport records;

Draft article 9. Procedures for use of negotiable electronic transport records;

Draft article 10. Replacement of negotiable transport document or negotiable electronic transport record; Draft article 59 (2)

26. The Working Group next considered the text of draft chapter 3, consisting of draft articles 8, 9 and 10, as well as the text of draft article 59 (2), which, it was recalled, had been discussed together as part of the group of provisions in the draft convention concerning electronic commerce when the Working Group had last considered the chapter. It was recalled that those provisions had also been the result of expert consultations with Working Group IV on electronic commerce, and that they were considered to be both carefully drafted and of a very technical nature.

Conclusions reached by the Working Group regarding chapter 3 and draft article 59 (2)

27. The Working Group was in agreement that the provisions of chapter 3 and of draft article 59 (2) were acceptable as set out in A/CN.9/WG.III/WP.81.

Chapter 4. Period of responsibility

Draft article 11. Period of responsibility of the carrier

28. The Working Group was reminded that its most recent consideration of draft article 11 on the period of responsibility of the carrier was at its sixteenth session (see A/CN.9/591, paras. 190 to 208). The Working Group proceeded to consider draft article 11 as contained in A/CN.9/WG.III/WP.81.

Paragraph 1

29. Clarification was requested regarding the different definitions of “carrier” (draft article 1 (5)) and of “performing party” (draft article 1 (6)) in the draft convention, such that the definition of “performing party” included employees, agents and subcontractors, while the definition of “carrier” did not. The question was raised whether this might cause ambiguity regarding when the period of responsibility commenced if the goods were received by the employee or agent of the carrier, and not by the carrier itself. It was explained that the draft convention had specifically attempted to avoid agency issues, but that at times, it was thought to be important to stress that a particular provision was intended to include carriers acting through their agents, and thus the term “carrier or performing party” had been

used, but that as a general matter, the employees of carriers would be included in the provision by virtue of their inclusion in the definition of performing parties.

Paragraph 2

30. Concern was expressed regarding the text of draft paragraph 2, since it was thought that the text as currently drafted confused the contractual time and location of receipt and delivery with the actual time and location of receipt and delivery. The view was expressed that, in any event, the location of delivery was irrelevant for the purposes of determining the period of responsibility of the carrier, and it was suggested that adjustments should be made to the text of draft paragraph 2 to reflect that view. However, there was support for the view that both the time and location of receipt for carriage and delivery were important to the definition of the period of responsibility, and that, in any event, setting the parameters of those terms was important for other provisions in the draft convention. It was further explained that draft paragraph 2 was intended as a further clarification of draft paragraph 1, and there was agreement that that relationship should be more clearly set out.

31. A question was also raised regarding whether the text of draft paragraph 2 (b) created a potential gap in the period of responsibility of the carrier, since unloading of the goods by the carrier to a warehouse owned by the carrier would signal the end of the period of responsibility of the carrier pursuant to draft paragraph 2 (b), but it was suggested that the period should extend to the time when the consignee actually collected the goods. In response, it was explained if there were storage by the carrier, it would likely be pursuant to an agreement between the shipper and the carrier, or pursuant to custom or usage, and that if there were no such agreement or custom, storage of the goods would fall within draft article 50 which was intended to work in conjunction with draft article 11 to avoid any gap in the responsibility of the carrier.

Drafting suggestions

32. In order to clarify the relationship between draft paragraphs 1 and 2, it was suggested that the phrase “For the purposes of paragraph 1 of this draft article” be added at the beginning of draft paragraph 2. Further, it was noted that draft article 2 (b) referred to “discharge or unloading”, while draft article 4 (b) referred only to “discharge”, and it was suggested that reference to “discharge” should be deleted, and that the term “unloading” should be used in both instances. Finally, clarification was requested regarding the consequences of a contract of carriage that violated draft paragraph 4, and modifications were suggested to the provision to the effect that a provision in the contract of carriage would be void to the extent that it violated the provisions of draft paragraph 4.

Conclusions reached by the Working Group regarding draft article 11

33. The Working Group was in agreement with the intended purpose of draft article 11 as set out in A/CN.9/WG.III/WP.81, and agreed with the drafting suggestions set out in the paragraph above. In addition, the Secretariat was requested to consider possible improvements that could be made to draft paragraph 1, in order to clarify the relationship between draft paragraphs 1 and 2 of the provision, and to consider how to revise the text to ensure that the period of responsibility of the carrier would not commence if the shipper failed to deliver the goods to the carrier as stipulated in the contract of carriage.

Draft article 12. Transport not covered by the contract of carriage

34. The Working Group was reminded that its most recent consideration of draft article 12 on transport not covered by the contract of carriage was at its ninth session (see A/CN.9/510, paras. 41 to 42). The Working Group proceeded to consider draft article 12 as contained in A/CN.9/WG.III/WP.81.

35. The Working Group was reminded that two alternatives for the second sentence of the provision appeared in the text in square brackets, for consideration by the Working Group.

36. As a general remark, the view was expressed that the text of draft article 12 seemed unusual, since it seemed to suggest that the carrier was doing a favour for the shipper rather than providing a service, and that in so doing, the carrier could limit any potential liability it incurred in fulfilling that service. It was also suggested that draft article 12 appeared in general to allow carriers to offer additional services to shippers. However, it was said that the provision might give rise to abuses by carriers wishing to avoid responsibility for the proper provision of that service. In response, it was observed that draft article 12 was intended to cover the situation where the shipper specifically requested the additional service, in the form of a so called “mixed contract”, that is, partly one of carriage, and partly one of freight forwarding, that could be covered by a single transport document. In addition, it was clarified that the intention of the draft article was, in fact, to emphasize that the scope of the draft convention was limited to coverage of the contract of carriage, but through this specific provision the draft convention would accommodate the situation where the carrier performed additional services for the shipper beyond the contract of carriage, at the risk and for the account of the shipper. By including a provision such as draft article 12, the intention was not to eliminate the carrier’s obligation in the performance of the additional service, but to emphasize that any liability arising from it was not pursuant to the contract of carriage, and was thus necessarily outside the scope of the draft convention. However, such additional service as performed by the carrier would still be subject to liability under other applicable legal regimes.

37. Some strong views were expressed in support of the deletion of draft article 12. However, it was noted that the draft provision was intended to eradicate a form of abuse, where the carrier would include standard form clauses in the contract of carriage to the effect that the carrier was only liable if it carried the goods on its own vessel. While such provisions were said to be less common today, it was suggested that draft article 12 was intended to protect shippers from such abuse, and that its deletion could allow this abusive practice to persist, creating ambiguity and unfairness. The prevailing view in the Working Group was in favour of retaining the draft provision.

The first variant of the second sentence

38. Support was expressed for the approach taken in the first variant of the second sentence set out in square brackets, particularly since requests by shippers for through bills of lading were increasingly a part of modern maritime carriage and in keeping with industry practice, for example, in cases where the carrier could not perform the inland carriage or the shipper’s own merchant haulage arrangements were required, but where a documentary credit required that the transport be covered by a single transport document. There was support in the Working Group for the approach taken in the first variant of the second sentence of the text, that

when the carrier acted as agent of the shipper outside of the carrier's obligations in the contract of carriage, the carrier should only be responsible as agent, and should not be subject to the draft convention with respect to those additional services.

39. However, concern was expressed that the text of the first variant was not clear as drafted, and a number of modifications to it were suggested. One suggestion was that the carrier should be liable for the entire period for which it arranged the additional carriage on behalf of the shipper. The view was also expressed that the text was unclear regarding whether the carrier had any liability to a third party document holder, and it was suggested that this type of provision could create a problem regarding the identity of the carrier, which might be dealt with under draft article 38. There was agreement within the Working Group that the drafting of the provision should be improved and clarified. One suggestion to assist in the clarification of the provision was to make clear in the title that it concerned a "mixed contract." It was also noted that the provision used two different terms, "specified transport" and "additional transport", and it was suggested that a review should be had in order to make consistent use of terminology.

40. Additional concern was raised regarding the apparent creation of an additional obligation of the carrier, which could entitle it to limit its liability for a breach of an obligation "under this Convention" pursuant to text of draft article 62 (1), even though the breach of obligation did not arise from the contract of carriage. A solution proposed to remedy this problem was to adjust the first variant to read: "If the carrier arranges the additional transport as provided in such transport document or electronic transport record, the carrier is deemed to do so on behalf of the shipper." Support was expressed in the Working Group for this proposed adjustment to the text of the first variant as set out in the second sentence of draft article 12.

The second variant of the second sentence

41. Some support was expressed for the approach taken in the second variant of the second sentence set out in square brackets. However, some modifications to that text were suggested, such as including in it the phrase, "unless otherwise agreed" in order to ensure that the text was only a default provision. An additional view was expressed that certain aspects of the second variant could be retained and expressed in the text of the provision as redrafted from the first variant. However, the Working Group did not take up the second variant of the second sentence in draft article 12.

Location of draft article 12 in the text

42. It was suggested that draft article 12 should be moved to another location in the text, possibly for insertion in chapter 5 following draft article 18.

Conclusions reached by the Working Group regarding draft article 12

43. After discussion, the Working Group decided that:

- The text of draft article 12 should be retained in the draft convention, incorporating the approach taken in the first variant of the second sentence, but clarifying the text considerably in light of the concerns set out in paragraphs 34 to 41 above; and
- Consideration should be given to the proper placement of the provision in the text of the draft convention.

Revised text of draft article 12

44. In light of the decisions made by the Working Group with respect to the text of draft article 12 (see above, para. 43), the Working Group continued its deliberations on the following revised text of the provision:

“Article 12. Transport not covered by the contract of carriage

“On the request of the shipper, the carrier may agree to issue a single transport document or electronic transport record that includes specified transport [that is not covered by the contract of carriage] [in respect of which it is not the carrier]. In such event, the responsibility of the carrier covers only the period of the contract of carriage. If the carrier arranges the transport that is not covered by the contract of carriage as provided in such transport document or transport record, the carrier does so on behalf of the shipper.”

45. It was explained that the revised text of draft article 12 contained alternative text in two sets of square brackets, and that the first set of square brackets contained text taken from draft article 12 as it appeared in A/CN.9/WG.III/WP.81, while the second set contained what was intended to express the same principles, but in clearer drafting. Further, the second sentence of the revised provision was said to be taken from the first variant of the text as it appeared in A/CN.9/WG.III/WP.81, as preferred by the Working Group, while the third sentence was included in order to describe, but not to regulate, the legal relationship between the carrier and the shipper, when the carrier arranged for additional carriage.

46. Support was expressed in the Working Group for the second variant in square brackets as being clearer than the first, and as being somewhat more in keeping with the text of the similar provision in article 11 of the Hamburg Rules, that referred to “a named person other than the carrier”. While there remained some expressions of a preference to delete the draft provision from the text, the Working Group was reminded that it had already made the decision to retain the concept of the text of draft article 12, subject only to redrafting. Some support was also expressed in the Working Group in favour of the first alternative in square brackets.

47. A suggestion was made to include both phrases in square brackets in the text, joining them with the word “and”, in order to make the meaning of the provision as clear as possible. There was broad support for this approach in the Working Group. Concern was raised that including both phrases might lead to confusion, since courts might conclude that the two phrases had different content or that both had to be satisfied in order to meet the requirements of the provision. There was some sympathy for that concern, and it was suggested that greater clarity could be achieved by inserting text along the lines of “and in respect of which is therefore not the carrier” after the first variant.

48. By way of further clarification, it was noted that the third sentence of the revised text was intended to make clear that if the carrier arranged transport that was not covered by the contract of carriage, the carrier who entered into the contract for that particular additional carriage would be the carrier for that leg, and that that carrier would be liable for the carriage under applicable law.

Conclusions reached by the Working Group regarding revised draft article 12

49. After discussion, the Working Group decided that:
- The alternative phrases in square brackets should both be retained and made conjunctive, possibly using text such as “and in respect of which is therefore not the carrier”, and the square brackets around them deleted;
 - The text of revised draft article 12 was otherwise acceptable to the Working Group.

Chapter 5. Obligations of the carrier**Draft article 13. Carriage and delivery of the goods**

50. The Working Group proceeded to consider article 13 as set out in A/CN.9/WG.III/WP.81. It was questioned why the phrase “place of destination” was used rather than the phrase “place of delivery” which was used elsewhere in the draft convention, such as in subparagraph 1 (c) of draft article 5. Support was expressed for the principle that there should be consistency in the use of terminology in the draft convention unless the use of different terminology was justified. In response, it was said that the use of the term “place of destination” was appropriate in the current context to clarify the main obligations of the carrier and distinguish it from the place of unloading which was often erroneously seen as a synonym of the place of destination. That view was supported.

Conclusions reached by the Working Group regarding draft article 13

51. The Working Group was in agreement that the text in draft article 13 as contained in A/CN.9/WG.III/WP.81 was acceptable.

Draft article 14. Specific obligations

52. The Working Group considered draft article 14 as contained in A/CN.9/WG.III/WP.81. It was proposed to add the words “and is the responsibility of” following the words “is to be performed by” in paragraph 2. It was said that these words were necessary given that paragraph 2 provided a derogation from draft article 14, paragraph 1 and should extend to permitting such derogation when the parties agreed that it should be responsibility of the shipper. In response, it was said that the current wording of draft article 14 represented a compromise and that the inclusion of a reference to the responsibility of the shipper would be confusing, in particular in the context of Chapter 8, which dealt with the obligations of the shipper to the carrier.

53. It was also said that the wording in paragraph 2 was overly broad and should be restricted so as to preclude carriers from routinely disclaiming liability for damage to the goods that occurred during the operations contemplated in the draft article. In response, it was said that the provision was not too broad, since it focused on very specific tasks, and was clearly restricted to loading, handling, stowage or discharge of the goods. It was suggested that draft article 14 should be read in the context of subparagraph 17 (3)(i) which provided an exoneration of the responsibility of the carrier for any loss or damage caused to the goods when the shipper carried out those tasks.

Conclusions reached by the Working Group regarding draft article 14

54. The Working Group was in agreement that the text in draft article 14, as set out in A/CN.9/WG.III/WP.81, was acceptable.

Draft article 15. Goods that may become a danger

55. The Working Group recalled that the concept of “an illegal or unacceptable danger” to the environment that appeared in the text in A/CN.9/WG.III/WP.56 had been changed to refer to a “danger to the environment” as an effort to introduce a more objective standard for the carrier to apply in respect of goods that might become a danger. However, it was said that that formulation might set a lower standard than the standard that applied under other international maritime conventions and might make it too easy for the carrier, for example, to find a justification for destroying the goods. Notwithstanding a suggestion to revert to the language contained in A/CN.9/WG.III/WP.56 by restoring the words “an illegal or unacceptable danger” to the environment, the Working Group recalled that that formulation had been rejected for the reason that it would be difficult for the carrier to judge when a danger to the environment was “illegal” or “unacceptable” under the laws of the various jurisdictions in which carriers operated. Instead, it was proposed that the word “reasonably” be inserted before the words “appear likely to” to introduce an objective standard against which a decision by the carrier to destroy allegedly dangerous goods could be measured.

56. A suggestion was made to add the words “and security of any country” at the end of draft article 15 to deal with matters that might not affect persons or goods but would nevertheless impact adversely on a country’s general security. That proposal did not receive sufficient support.

Conclusions reached by the Working Group regarding draft article 15

57. The Working Group agreed that the word “reasonably” be added before the words “appear likely to” in the text in draft article 15 as set out in A/CN.9/WG.III/WP.81. Subject to that amendment, the Working Group was in agreement that the text of draft article 15 was acceptable.

Draft article 16. Specific obligations applicable to the voyage by sea**Paragraph 1**

58. A proposal was made to delete subparagraphs (b) and (c) of draft article 16 (1) for the reason that the substance of both subparagraphs was already encompassed by subparagraph (a) which referred to making and keeping the ship seaworthy. However, support was expressed for maintaining separate subparagraphs. It was said that the formulation set out in subparagraphs (a), (b) and (c) represented the approach long taken in the Hague Rules and the Hague-Visby Rules. The only change that had been made was to render the carrier’s obligation of a continuing nature, that is, one that applied throughout the voyage, rather than only before it started. It was cautioned that any departure from those well-known standards of due diligence could create problems in interpretation.

Conclusions reached by the Working Group regarding paragraph 1 of draft article 16

59. The Working Group agreed that the paragraph (1) of draft article 16 as set out in A/CN.9/WG.III/WP.81 was acceptable and should be retained.

Paragraph 2

60. The Working Group recalled that it had previously approved the substance of paragraph 2 but that the location of the paragraph was still to be determined. It was noted that the purpose of draft article 15, which focussed on destroying or rendering harmless dangerous goods, was entirely different from the purpose of draft article 16, paragraph 2, whereby goods not necessarily of a dangerous nature were sacrificed in the interests of common safety.

61. Some support was expressed for including paragraph 2 in chapter 17 on general average if that chapter were to be retained in the final text of the draft convention. A suggestion was made to place the paragraph in the article on deviation if the chapter on general average were ultimately not retained. It was pointed out that although the exercise of the rights under paragraph 2 by the carrier might give rise to claims in general average in some cases, it would not do so in all cases. Thus it was said that it might be more appropriate to place the text in paragraph 2 in a separate article. That proposal was supported.

Conclusions reached by the Working Group regarding paragraph 2 of draft article 16

62. The Working Group agreed that the text contained in paragraph 2 of draft article 16 and set out in A/CN.9/WG.III/WP.81 was acceptable, that the square brackets should be deleted and the text therein be retained in a separate article, possibly numbered as article 16 bis.

Chapter 6. Liability of the carrier for loss, damage or delay**Draft article 17. Basis of liability**

63. The Working Group was reminded that its most recent consideration of draft article 17 on the basis of liability was at its fourteenth session (see A/CN.9/572, paras. 12 to 80). The Working Group proceeded to consider draft article 17 as contained in A/CN.9/WG.III/WP.81. It was recalled that the text of draft article 17 as currently drafted was the result of a broad and carefully negotiated consensus that emerged from intense discussions in the Working Group over several sessions. It was suggested that the entire structure of the draft article should be kept in mind when considering particular paragraphs, and that caution should be exercised in suggesting any changes to the carefully balanced text.

Paragraph 1

64. The Working Group was in agreement that draft paragraph 1 should be approved as drafted.

Paragraph 2

65. The view was expressed that, while there was broad agreement on the text of draft article 17, certain changes should be made to paragraph 2 in order to remedy some perceived shortcomings. In particular, it was thought that the list set out in paragraph 3 of draft article 17 was exhaustive in terms of events that could relieve a carrier of liability, and that paragraph 6 covered the situation where the damage to the goods was caused only partly by the carrier, but that article 2 allowed the carrier to escape liability where two causes of the damage existed, either of which could have caused the entire loss, but only one of which was attributable to the carrier.

It was suggested that to remedy this perceived shortcoming, the phrases “all or part of” and “or one of the causes” should be deleted from the text of paragraph 2.

66. While some sympathy was expressed for that position, it was pointed out that similar issues had been raised in the Working Group during its fourteenth session, and that the overwhelming view of the Working Group at that time was that it supported the text as currently drafted. Moreover, it was suggested that the apparent problem articulated would be properly solved through the application of the current text even though it did not precisely take the issue into account. Further, it was indicated that the draft convention had deliberately avoided the discussion of issues of causality, leaving it to national law, and that there was thus insufficient reason to disturb the complex series of compromises represented in the drafting of the current text. A suggestion was made for the insertion of a provision clarifying that causation and related matters, such as comparative negligence, were left to national law.

67. The Working Group was in agreement that draft paragraph 2 should be approved as drafted.

Paragraph 3

68. A number of delegations expressed support for the deletion of paragraph 3 of draft article 17, which was said to provide carriers with an excessively generous list of exonerations, while some other delegations suggested that the deletion of error of navigation from this paragraph during previous sessions of the Working Group should be reviewed, or at least borne in mind by the Working Group in assessing the overall balance of liabilities in the draft convention. The Working Group nevertheless expressed its strong support for the inclusion of paragraph 3 as drafted. In support of this position, a number of delegations cited the delicate balance and consensus that was reached by the Working Group in the negotiation of the entire draft article, and the support during past sessions for the inclusion of paragraph 3 in the draft convention.

Bracketed text in subparagraphs (g), (h), (i) and (k)

69. The Working Group next considered the text in paragraph 3 that remained in square brackets. With respect to subparagraph (h), it was suggested that the square brackets around the phrase “the consignor” should be lifted and the text retained since, although the draft convention did not concern itself with matters of agency, it was thought to be good policy that the carrier should not be held liable for acts of the consignor that caused damage to the goods. With respect to subparagraph (i), it was suggested that the square brackets around the phrase “or a performing party” should be removed and the text retained, and that in the case of subparagraph (k), that the square brackets around the text “or on behalf of” should be deleted and the text retained. While there was some support for the deletion of the text in square brackets as found in these subparagraphs, overall, these inclusions were thought to clarify the text of the various subparagraphs, and the Working Group supported the proposals to include them.

70. In the case of subparagraph (g), it was proposed that both of the variants that appeared in square brackets should be deleted along with the words “in the”, thus leaving the text substantially as it appeared in article 4 (2)(p) of the Hague-Visby Rules. Concern was expressed that choosing the “ship” variant would unduly restrict the previously broader approach in the Hague-Visby Rules that included, for example, cranes, but that the alternative “means of transport” was too broad, even

though the draft convention was intended to be a “maritime plus” convention. While some support was expressed for each of these two variants, the prevailing view was that the best approach was to retain the approach taken in the Hague-Visby Rules and delete both variants.

Conclusions reached by the Working Group regarding draft paragraph 3

71. After discussion, the Working Group decided that:

- The text of draft paragraph 3 should be retained in the draft convention as drafted;
- The text in both sets of square brackets in subparagraph (g) should be deleted along with the words “in the”; and
- The text in square brackets in subparagraphs (h), (i) and (k) should be retained and the brackets deleted.

Paragraph 4

72. A proposal to add the phrase “listed in paragraph 3” after the word “circumstance” in subparagraph (a) was not accepted, and the Working Group was in agreement that draft paragraph 4 should be adopted as drafted.

Paragraph 5

73. A proposal to shift the burden of proof in subparagraph (a) of the draft provision from the claimant to the carrier in order to reduce the burden of proof on the shipper was not accepted by the Working Group. In response to a question regarding the intention of subparagraph (b) of the text, it was clarified that the intended scheme of paragraph 5 was that the cargo claimant would have to prove the probable cause of the loss, damage or delay under subparagraph (a), and that subparagraph (b) provided the carrier with the possibility of counterproof. It was observed that any ambiguity regarding this intention should be rectified. The Working Group was in agreement that draft paragraph 5 should be adopted as drafted, with any necessary clarification as noted above.

Paragraph 6

74. The Working Group was in agreement that draft paragraph 6 should be approved as drafted.

Draft article 18. Liability of the carrier for other persons

Paragraph 1

75. Noting that paragraph 1 (b) of draft article 19 and article 34 related to auxiliary persons to the maritime performing party and to the shipper, respectively, it was proposed that the language used in both the articles should be mirrored in paragraph 1 of draft article 18, which dealt with auxiliary persons to the carrier. It was proposed that paragraph 1 (b) be redrafted along the following lines, “any person to which the carrier has entrusted the performance of any of its obligations under the contract of carriage”. It was said that that redraft would provide a simpler formulation that would better clarify that the carrier was not responsible for the acts of a person under its supervision or control if that person had not been entrusted with the performance of the carrier’s obligations. That proposal was not supported.

Conclusions reached by the Working Group regarding paragraph 1

76. The Working Group agreed to retain the text of paragraph 1 as contained in A/CN.9/WG.III/WP.81.

Paragraph 2

77. Some support was expressed for retention of the text set out in paragraph 2, which was currently contained in square brackets. It was said that its retention would promote greater international uniformity. However, strong support was expressed for the deletion of the paragraph for the reason that determination of the scope of employment contracts or agency should be left to national law. In response, it was pointed out that, as drafted, paragraph 2 did not affect national law and that its application even relied on rules of national law. Furthermore, the provision was not concerned with the carrier's own employees but only with the carrier's vicarious liability for the acts of other parties. If an employee acted outside his or her employment contract, a carrier would probably not be relieved of liability given that that event would not be covered by the list contained in draft article 17 (3). Nevertheless strong support was expressed for the deletion of paragraph 2 in order to leave matters of the scope of employment contracts and agency to national law.

Conclusions reached by the Working Group regarding paragraph 2

78. The Working Group agreed to delete the text of paragraph 2 as contained in A/CN.9/WG.III/WP.81.

Paragraph 3

79. The Working Group proceeded to consider a proposal as contained in A/CN.9/WG.III/WP.85 (see para. 3) to clarify by adding a new paragraph 3 to article 18 that a carrier would not be liable for loss of or damage to the goods to the extent that it was attributable to an act or omission of another shipper. It was noted that the proposal was aimed at addressing the concern expressed at an earlier session that, under the draft convention, carriers might nevertheless be found liable to other shippers with goods on board that vessel for a delay caused by only one shipper (A/CN.9/616, para. 103).

80. Some support was expressed for the inclusion of the proposed text. It was suggested that, notwithstanding the Working Group's support for the exclusion of shipper liability for delay from the draft convention, a shipper could still cause delay and damage to other shippers. Nevertheless, if the Working Group agreed to include the proposed text, its placement and wording should still be considered. The proposed text might fit better in article 17, paragraph 3, which dealt with carrier liability. It was also said that the proposed additional language which referred to "another shipper" was ambiguous and should instead refer to "another shipper under another contract of carriage".

81. The Working Group, however, was of the view that the proposed text was unnecessary as its content was already adequately covered by the liability regime set out in draft article 17.

Conclusions reached by the Working Group regarding proposal to add paragraph 3 of draft article 18

82. The Working Group did not support the proposal to add paragraph 3 of draft article 18 as contained in A/CN.9/WG.III/WP.85.

Draft article 19. Liability of maritime performing parties

83. It was clarified that the language in the bracketed text in paragraph 1 of draft article 19 was intended to ensure that maritime performing parties would not be covered by the draft convention if they did not perform any of their activities in a Contracting State. Whilst there was some support for the deletion of the bracketed text, there was strong support for the retention of the language. In that respect, it was pointed out that the exclusion of maritime performing parties did not mean that carriers would not be liable for the acts of these performing parties. Rather, it meant that the shipper or consignee would not have a direct cause of action against the maritime performing party under the draft convention, and that such maritime performing party would not automatically enjoy the same exoneration and limits on liability that applied to the carrier under the draft convention.

Conclusions reached by the Working Group regarding paragraph 1

84. The Working Group agreed to retain the text of paragraph 1 of draft article 19 as contained in A/CN.9/WG.III/WP.81 and delete the brackets.

Paragraph 2

85. The Working Group proceeded to consider paragraph 2 of draft article 19 as set out in A/CN.9/WG.III/WP.81. The Working Group took the view that, in light of the decision taken to delete paragraph 2 of draft article 18, paragraph 2 of draft article 19 should also be deleted.

Conclusions reached by the Working Group regarding paragraph 2

86. The Working Group decided that the text in paragraph 2 of draft article 19 as found in A/CN.9/WG.III/WP.81 should be deleted.

Paragraph 3

87. Given the broad formulation of the definition of maritime performing party, a proposal was made to delete paragraph 3 for the reason that it would not be fair to the consignee to allow a carrier to enforce the limitation of liability with respect to additional obligations or to higher liability limits that it agreed to, but to refuse to bind the maritime performing party to those same limits absent express agreement. However, support was expressed for retention of that paragraph. It was said that if the contractual carrier agreed to increase liability beyond that provided for in the draft convention, it would be illogical to impose such liability on the maritime performing party who might not even be a party to that agreement.

Conclusions reached by the Working Group regarding paragraph 3

88. The Working Group was in agreement that the text in paragraph 3 of draft article 19 as found in A/CN.9/WG.III/WP.81 should be retained, subject to any changes to cross-references that might be necessary once the text of the draft convention was finalized.

Paragraph 4

General comments and placement

89. Support was expressed for the general policy behind paragraph 4, which was to afford employees, agents and subcontractors of the carrier and maritime performing parties the full protection of the rights, defences and limits of liability available to the carrier under the draft convention for any breach of its contractual obligations or duties in the event that an action under the draft convention was made directly against it, a protection which was often sought through the insertion of so-called “Himalaya” clauses in transport documents. It was agreed that the term “defences and limits of liability” should be interpreted broadly, as had been agreed by the Working Group in connection with draft article 4.

90. A concern was expressed that it was not clear whether or not employees of the carrier were dealt with anywhere else than paragraph 4 in the draft convention. For example, subparagraph 1 (b) of draft article 18, which referred to persons that performed the carrier’s obligation, did not appear to encompass the carrier’s employees. It was suggested that a Himalaya clause should be extended to apply to any person who assisted the carrier in performing its duties. To that end, a proposal was made to expand paragraph 4 so as to encompass the full category of parties that performed the carrier’s obligations under the draft convention, including its employees and agents. A suggestion was made that the master and crew of the ship should also be covered as well as independent contractors. A view was expressed that the existing definitions of performing party and maritime performing party were broad enough to include these persons. Given the different possible interpretations, it was agreed that these definitions should be clarified. In that respect, it was stated that, in the situation where crew members were not employees of the carrier but rather employees of the ship owner or of a crew company should also be taken into account.

91. It was proposed that, as paragraph 4 dealt with matters different from exemptions for maritime performing parties, it might be more appropriately located following article 4 in Chapter 1 of the draft convention which dealt with general provisions. Some support was expressed for that suggestion.

Bracketed text

92. The Working Group proceeded to consider the three alternative bracketed texts.

93. Some support was expressed for the retention of the first bracketed text. However, it was suggested that if the first bracketed text, which referred only to maritime performing parties, were retained, then paragraph 4 could be deleted as it was already covered by paragraph 1 of draft article 19.

94. Strong support was expressed for retaining the second bracketed text. In that respect, it was noted that article 4 bis (2) of the Hague-Visby Rules extended the protection of a Himalaya clause to servants or agents of the carrier, as such protection was not always valid in all jurisdictions.

95. Some support was expressed for the third bracketed text for the reason that it was said to better reflect that the draft convention applied to multimodal rather than traditional port-to-port transportation. It was suggested that the words “or subparagraph 1 (a) of this article,” could also be deleted. However, concern was expressed that the third bracketed text appeared to bring agents and servants of

inland carriers within the scope of Himalaya protection which would not be consistent with the Working Group's decision to exclude inland carriers from the scope of the draft convention.

"if [it proves that] it acted within the scope of its contract, employment or agency"

96. Although some support was expressed for its retention, there was a consensus to delete the entire phrase "if [it proves that] it acted within the scope of its contract, employment or agency".

Conclusions reached by the Working Group regarding paragraph 4

97. The Working Group was in agreement that:

- The second bracketed text in paragraph 4 of draft article 19 as found in A/CN.9/WG.III/WP.81 be retained without the brackets;
- Paragraph 4 and the definitions of "performing party" and "maritime performing party" be reconsidered and possibly redrafted to specify who precisely was covered by the Himalaya protection clause and consideration be given as to whether the crew, master, independent contractors and employees of the carrier were also covered;
- The final part of paragraph 4, "if [it proves that] it acted within the scope of its contract, employment or agency" be deleted in accordance with the decision to delete paragraph 2 of article 18 and leave matters relating to the scope of employment contracts and agency to national law (see paras. 77 to 78 above); and
- That the location of paragraph 4 be reconsidered, taking account of the suggestions of the Working Group.

Draft article 20. Joint and several liability and set-off

Paragraph 1

98. The Working Group proceeded to consider paragraph 1 of draft article 20 as set out in A/CN.9/WG.III/WP.81 noting that it contained bracketed text which was intended to clarify what was meant by the term "joint and several liability". Support was expressed for retention of the bracketed text for those jurisdictions where joint and several liability was not well-recognized in order to assist in a harmonized interpretation of those terms. However, opposition was expressed to retaining the text in square brackets, since it was noted that a number of international conventions also used these terms but did not include definitions. Concerns were expressed that the inclusion of such definitions might thus have adverse interpretative consequences. It was also suggested that the definitions were overly simplistic and might not sufficiently capture the subtle differences in the use of the terms in different jurisdictions.

99. A suggestion was made to delete the references to articles 25, 62 and 63 given that these limits would apply regardless of whether or not they were listed. That proposal did not receive sufficient support.

Conclusions reached by the Working Group regarding paragraph 1

100. The Working Group agreed to the deletion of the bracketed text in paragraph 1.

Paragraph 2

101. It was agreed that the phrase “all such persons” was intended to cover all parties that were jointly or severally liable. It was questioned how paragraph 2 would operate in situations where a carrier had contracted out of the provisions of the draft convention, and had increased its liability limit. In response, it was suggested that the overall limit of liability referred to in this provision was intended to include a voluntary increase in the limitation on the carrier’s liability, which would then become the amount referred to in draft paragraph 2.

Conclusions reached by the Working Group regarding paragraph 2

102. The Working Group agreed to retain the text of paragraph 2.

Paragraph 3

103. The Working Group proceeded to consider draft paragraph 3 as set out in A/CN.9/WG.III/WP.81. The Working Group was reminded that the aim of paragraphs 1 and 2 was that the overall limits of liability should not be circumvented by a claimant suing more than one party. Paragraph 3 was included to avoid the possibility that might arise in some jurisdictions that a court might find that a claimant who successfully sued a non-maritime performing party should not have the amount awarded set off against a claim made under the draft convention. It was suggested that paragraph 3, as drafted, was capable of two interpretations: either it operated to set off the amount recovered from suing outside of the draft convention against the total amount of the damage, or it operated to set off the amount recovered from the limitation on liability in the draft convention. There was support for the view that the first interpretation was acceptable, and would, in fact, be the conclusion reached in most jurisdictions, but that the second interpretation was not acceptable. It was clarified that the second interpretation had been the one sought in the original proposal for the inclusion of this paragraph in the draft convention.

104. Support was expressed for the deletion of paragraph 3 as being both unclear in its effect, and for the reason that it might introduce procedural difficulties such as determining who bore the onus of proving whether or not an action had been successfully brought against the non-maritime performing party.

Conclusions reached by the Working Group regarding paragraph 3

105. The Working Group agreed to delete the text of paragraph 3.

Draft article 22. Calculation of compensation

106. The Working Group was reminded that its most recent consideration of draft article 22 on the calculation of compensation was at its thirteenth session (see A/CN.9/552, paras. 32 to 37). The Working Group proceeded to consider draft article 22 as contained in A/CN.9/WG.III/WP.81.

Paragraph 1

107. Bearing in mind that the reference in draft paragraph 1 to draft article 11 might have to be revisited should any adjustments be made to the text of draft article 11, the Working Group was in agreement that draft paragraph 1 should be approved as drafted.

Paragraph 2

108. A suggestion was made that the order of factors to be used in determining the value of goods under draft paragraph 2 should be altered so that the market value would be taken into account before the commodity exchange price. However, that view received insufficient support and draft paragraph 2 was approved as drafted.

Paragraph 3

109. The Working Group was in agreement that draft paragraph 3 should be approved as drafted.

Draft article 23. Notice of loss, damage or delay

110. The Working Group was reminded that its most recent consideration of draft article 23 on notice of loss, damage or delay was at its thirteenth session (see A/CN.9/552, paras. 63 to 87). The Working Group proceeded to consider draft article 23 as contained in A/CN.9/WG.III/WP.81.

Paragraph 1*Legal effect of draft paragraph 1*

111. Concern similar to that expressed during the thirteenth session of the Working Group (see A/CN.9/552, para. 65) was reiterated regarding the operation of draft paragraph 1. There was support for the view that paragraph 1 was unnecessary since the issuance of the notice to the carrier or the performing party, or the failure to provide such a notice, did not affect the respective burdens of proof of the carrier and of the claimant as set out in the general liability regime in draft article 17. Moreover, it was noted that in some jurisdictions, the provision on which this draft article was based, article 3 (6) of the Hague Rules, had caused confusion and had led some courts to conclude that failure to provide such a notice resulted in the loss of the right to claim for loss or damage pursuant to the instrument. As such, the Working Group was urged to delete draft paragraph 1, and, failing that, to make it clear that failure to provide the notice under the draft provision was not intended to have a special legal effect.

112. In response, it was noted that the draft paragraph was not intended to attach a specific legal effect to the failure to provide notice. Nevertheless, the draft provision was intended to have the positive practical effect of requiring notice of the loss or damage as early as possible to the carrier, so as to enable the carrier to conduct an inspection of the goods, assuming there had been no joint inspection. While there was no agreement in the Working Group to reverse its earlier decision to retain the draft paragraph, there was agreement that draft paragraph 1 was not intended to affect the rights of cargo interests to make claims under the draft convention, and that it was in particular not intended to affect the liability regime and burdens of proof set out in draft article 17.

Time period

113. There was some support in the Working Group for the selection of a notice period of three working days from the alternatives appearing in the draft text in square brackets, particularly in light of the purpose of the draft paragraph to encourage that inspections of the damaged goods should take place as early as possible. However, the Working Group expressed a preference that a notice period

of seven working days at the place of delivery should be chosen from among the alternatives presented.

Conclusions reached by the Working Group regarding draft paragraph 1

114. After discussion, the Working Group decided that:

- The text of draft paragraph 1 should be retained in the draft convention as drafted;
- The text in square brackets “seven working days at the place of delivery” should be retained and the brackets removed, and all other alternative time periods in square brackets should be deleted; and
- It should be made clear that draft paragraph 1 was not intended to have any evidentiary effect nor was it intended to conflict with or affect the liability regime and burdens of proof set out in draft article 17 in any way.

Paragraph 2

115. It was agreed that the discussion of this paragraph would be postponed until the broader consideration by the Working Group of shipper and carrier delay.

Paragraph 3

116. It was observed that the phrase “same effect” in draft paragraph 3 referred to the notice referred to in draft paragraph 1, which was thought in that context to have no special legal effect (see above, para. 112). The Working Group was in agreement that draft paragraph 3 should be approved as drafted.

Paragraph 4

117. The Working Group agreed that draft paragraph 4 should be adopted as drafted.

Chapter 7. Additional provisions relating to particular stages of carriage

Draft article 24. Deviation during sea carriage

118. The Working Group was reminded that its most recent consideration of draft article 24 on deviation during sea carriage was at its thirteenth session (see A/CN.9/552, paras. 100 to 102). The Working Group proceeded to consider draft article 24 as contained in A/CN.9/WG.III/WP.81.

119. The Working Group agreed that draft article 24 should be approved as drafted.

Draft article 25. Deck cargo on ships

120. The Working Group was reminded that its most recent consideration of draft article 25 on deck cargo on ships was at its thirteenth session (see A/CN.9/552, paras. 103 to 117). The Working Group proceeded to consider draft article 25 as contained in A/CN.9/WG.III/WP.81. A general remark was made questioning whether chapter 7 was the appropriate placement for draft article 25.

Paragraphs 1, 2, 3 and 4

121. The Working Group agreed that draft paragraphs 1, 2, 3 and 4 should be approved as drafted.

Paragraph 5

122. It was noted that draft paragraph 5 appeared in the text in square brackets, and that the provision also contained four sets of square brackets in the text itself.

Text of the entire paragraph and placement

123. The view was expressed that draft paragraph 5 should be deleted in its entirety, and that in all cases under the draft convention, resort should be had to draft article 64 in the cases of loss of or damage to goods improperly carried as deck cargo. It was clarified, however, that the intention of draft paragraph 5 was not to lower the general threshold for the loss of the benefit of the limitation on liability in draft article 64, which should be kept as the general rule under the draft convention. It was appropriate, however, to treat a breach by the carrier to its express promise to carry goods under deck as a case warranting a special sanction.

124. There was broad agreement in the Working Group that the square brackets around the draft paragraph should be lifted and the text of the paragraph retained. A proposal was made that the draft paragraph should be moved to become a new subparagraph of draft article 24 but was not taken up. However, there was agreement to the drafting suggestion that the phrase “not entitled to limit its liability” in draft paragraph 5 should be adjusted to be consistent with the phrase used in draft article 64 “not entitled to the benefit of the limitation of liability”.

“[expressly]”, “[[that solely][to the extent that such damage] resulted from their carriage on deck]”

125. The Working Group next considered the text that appeared in square brackets in the draft provision. While there were some views expressed to the contrary, the Working Group agreed to retain the word “expressly” and to delete the square brackets surrounding it; to delete the phrase “that solely”, including square brackets surrounding it; to retain the phrase “to the extent that such damage” and to delete the square brackets surrounding it; and to retain the phrase “resulted from their carriage on deck” and delete the square brackets surrounding the entire final phrase. It was felt that the requirement of an express agreement to trigger the loss of the benefit of the liability limits was important so as to make foreseeable for the carrier its exposure to that sanction. Furthermore, the phrase “to the extent that such damage” was to be preferred over the words “that solely”, since it was in keeping with the general approach to causation in the draft convention.

Conclusions reached by the Working Group regarding draft paragraph 5

126. After discussion, the Working Group decided that:

- The text of draft paragraph 5 should be retained in the draft convention as drafted and the square brackets around it deleted;
- The phrase “not entitled to limit its liability” in draft paragraph 5 should be adjusted to be consistent with the phrase used in draft article 64 “not entitled to the benefit of the limitation of liability”; and

- The draft paragraph should reflect the text chosen by the Working Group from the alternatives presented, as set out in paragraph 125 above.

Chapter 1. General provisions

Draft article 1. Definitions

127. In accordance with its earlier decision to consider definitions in keeping with the consideration of the substantive articles containing defined terms (see para. 9 above) the Working Group proceeded to consider the definitions of “performing party”, “maritime performing party” and “non-maritime performing party” as contained in paragraphs 6, 7 and 8, respectively, of draft article 1 as contained in A/CN.9/WG.III/WP.81.

Paragraphs 6 and 7 — “performing party” and “maritime performing party”

128. The Working Group noted that the definition of “performing party” contained two sentences: the first described a performing party, and the second extended that initial definition to include employees, agents and subcontractors. It was noted that the purpose of the definition of “performing party” was to regulate three different issues, which should not be confused. First, the definition was intended to govern parties that performed the carrier’s activities under a contract of carriage, usually subcontractors, and their joint and several liability with the contracting carrier. Secondly, the definition was aimed at regulating the vicarious liability of the performing party for its employees or others working in its service. Finally, the definition, in conjunction with draft articles 4 and 19, was aimed at extending the protection of the so-called “Himalaya clause” to such employees, agents or subcontractors.

129. It was noted that the definition of “maritime performing party” referred back to the definition of “performing party” and thus it also included employees, agents and subcontractors. It was suggested that, as formulated, the definition could have the unintended effect that any possible contractual liability of a maritime performing party under the contract of carriage could be imposed directly on an employee, agent or subcontractor, and there was support for the view that the definition of “performing party” should be reconsidered to avoid such an unintended consequence. In that respect, it was noted that, as drafted, the unintended consequence of rendering employees directly contractually liable would be inconsistent with many national laws which protected employees from such liability.

130. In response, it was explained that the reason that the definition had been framed so broadly was in order to avoid the privity of contract problem that had arisen in the jurisprudence with respect to Himalaya clauses that allowed for such protection under the clause only for subcontractors, but not for those further down the chain of contracts. In addition, it was said that it was difficult to envisage from both a practical and, in some countries, a legal perspective, a situation where an individual employee would be held responsible as a maritime performing party, including all of the liabilities that would follow therefrom. It was suggested that, in practice, it would be unlikely that a cargo owner would sue an employee directly on the basis that litigants tended to sue those with the greatest financial means to satisfy a judgement. It was cautioned that, if the definition were to be reformulated, care should be taken to avoid the accidental removal of the vicarious liability of employers, and, since reference was made throughout the draft convention to

“performing parties” and “maritime performing parties”, caution was also advised against changes that could have unintended consequences elsewhere in the text.

131. It was suggested that the reformulation of the definition should be considered by the Working Group. It was agreed that any reformulation should consider the substantive articles throughout the text that referred to the definition and should be based on the following guiding principles:

- Carriers and subcontractors should have joint and several liability;
- Carriers and employers should be vicariously liable for their employees; and
- The protection of the so-called “Himalaya clause” should apply to employees in the same way that it applied to employers and not be limited in operation by the principle of privity of contract.

Proposal to exclude rail carriers

132. The Working Group was reminded of its policy decision to exclude inland carriers from the draft convention.

133. As set out in A/CN.9/WG.III/WP.84, a proposal was made that rail carriers, even if performing services within a port, should be excluded from the definition of “maritime performing party.” To that end, it was suggested that the following sentence be added at the end of draft article 1, paragraph 7 (the definition of “maritime performing party”): “A rail carrier, even if it performs services that are the carrier’s responsibilities after arrival of the goods at the port of loading or prior to the departure of the goods from the port of discharge, is a non-maritime performing party.”

134. In support of the proposal, it was suggested that such an exemption was warranted given the practical reality that although rail carriers might be somewhat similar to other inland carriers in that they collected cargo or delivered it for carriage within a port area, rail carriers differed dramatically from other inland carriers in that the ultimate purpose of their services was virtually exclusively to move goods great distances into or out of a port, and not simply to move goods from one place to another within a port.

135. It was questioned whether a specific exemption was necessary given that the existing text of the draft convention made it clear that such inland carriers were almost invariably classified as such and not covered by the definition of maritime performing party, thus falling outside of the scope of the draft convention. In response, it was said that without an express provision, courts would be required to undertake an analysis on a case-by-case basis to determine if a rail carrier was covered by the definition or not. It was said that an express exemption provided clarity and would reduce litigation on that question.

136. Concern was expressed that the consequences of a blanket exemption for rail carriers had not been fully considered. One issue raised was the problem that a catalogue of carriers of various types might seek to be similarly exempted from the scope of application of the draft convention. In addition, a view was expressed that a preferable approach to a blanket exemption might be to provide more clearly in the text that the draft convention did not apply if maritime transport was neither contemplated nor actually performed, since it was suggested that freight forwarders

needed the flexibility to perform contracts of carriage in the manner they saw fit, including the right to use the optimal modes of transport.

137. Further, it was questioned why such an exemption should be limited to rail carriers. Some support was expressed for the view that the proposed exemption should also extend to road carriers (as suggested in A/CN.9/WG.III/WP.90) and possibly to inland barges. In that respect it was said that, unlike rail carriers, truckers might perform purely inland carriage as well as services that were exclusively within the port area, and that therefore any exemption for road carriage might need to be formulated in different terms than that which applied to rail carriage. It was suggested that an exemption for both road and rail carriers might be drafted too broadly and thus exempt truckers who exclusively provided services in the port area and should be treated as “maritime performing parties”. One suggestion to allow for a more nuanced approach to the problem was an exemption drafted along the following lines: “a rail carrier or road carrier is a maritime performing party only when it performs or undertakes to perform its services exclusively within the port area”. That proposal received some support.

Conclusions reached by the Working Group regarding draft paragraphs 6 and 7

138. After discussion, the Working Group decided to postpone its decision on the definitions of “performing party” and “maritime performing party” pending an examination of redrafted provisions, including a possible exemption for rail and possibly other inland carriers from the definition of maritime performing party, taking into account the proposals made in the Working Group.

Paragraph 8 — “non-maritime performing party”

139. The Working Group noted that the term “non-maritime performing party” was only used in draft article 20, paragraph 3. In light of its earlier decision to delete that paragraph (see para. 105 above), the Working Group agreed that that definition be deleted.

Conclusions reached by the Working Group regarding draft paragraph 8

140. The Working Group agreed that the definition of “non-maritime performing party” contained in draft paragraph 8 be deleted.

Revised text of draft articles 1 (6) and 1 (7) (“performing party” and “maritime performing party”); and draft articles 4, 18 and 19

141. In accordance with its earlier decision to reconsider the reformulated definitions of “performing party” and “maritime performing party” as originally contained in paragraphs 6 and 7, respectively, of draft article 1 (see above, para. 138), the Working Group continued its deliberations on the following revised text of those provisions, as well as consequential changes to draft articles 4, 18 and 19:

“Article 1. Definitions

“6. (a) “Performing party” means a person other than the carrier that performs or undertakes to perform any of the carrier’s obligations under a contract of carriage with respect to the receipt, loading, handling, stowage, carriage, care, discharge or delivery of the goods, to the extent that such person acts, either directly or indirectly, at the carrier’s request or under the

carrier's supervision or control. It includes agents or subcontractors of a performing party to the extent that they likewise perform or undertake to perform any of the carrier's obligations under a contract of carriage.

“(b) Performing party does not include:

“(i) an employee of the carrier or a performing party; or

“(ii) any person that is retained, either directly or indirectly, by a shipper, by a documentary shipper, by the consignor, by the controlling party or by the consignee instead of by the carrier.

“7. “Maritime performing party” means a performing party to the extent that it performs or undertakes to perform any of the carrier's obligations during the period between the arrival of the goods at the port of loading of a ship and their departure from the port of discharge of a ship, but, in the event of a trans-shipment, does not include a performing party that performs any of the carrier's obligations inland during the period between the departure of the goods from a port and their arrival at another port of loading. An inland carrier is a maritime performing party only if it performs or undertakes to perform its services exclusively within a port area.

“Article 4. Applicability of defences and limits of liability

“[renumber current article 4 as paragraph 1]

“2. If judicial or arbitral proceedings are instituted in respect of loss or damage [or delay] covered by this Convention against master, crew or any other person who performs services on board the ship or employees or agents of a carrier or a maritime performing party that person is entitled to defences and limits of liability as provided for in this Convention.

“3. Paragraph 2 applies whether judicial or arbitral proceedings are founded in contract, in tort or otherwise.

“Article 18. Liability of the carrier for other persons

“The carrier is liable for the breach of its obligations pursuant to this Convention caused by the acts or omissions of:

“(a) Any performing party;

“(b) Master or crew of the ship;

“(c) Employees or agents of the carrier or a performing party; or

“(d) Any other person that performs or undertakes to perform any of the carrier's obligations under the contract of carriage, to the extent that the person acts, either directly or indirectly, at the carrier's request or under the carrier's supervision or control.

“Article 19. Liability of maritime performing parties

“1. A maritime performing party that initially received the goods for carriage in a Contracting State, or finally delivered them in a Contracting State, or performed its activities with respect to the goods in a port in a Contracting State if the occurrence that caused the loss, damage or delay took place during the period between the arrival of the goods at the port of loading of a ship and their departure from the port of discharge from a ship, when it

has custody of the goods or at any other time to the extent that it is participating in the performance of any of the activities contemplated by the contract of carriage:

“(a) Is subject to the obligations and liabilities imposed on the carrier under this Convention and is entitled to the carrier’s defences and limits of liability as provided for in this Convention, and

“(b) Is liable for the breach of its obligations pursuant to this Convention caused by the acts and omissions of any person to which it has entrusted the performance of any of the carrier’s obligations under the contract of carriage. ...”

142. It was explained that the three guiding principles agreed upon by the Working Group with respect to the reformulation of the definitions of “performing party” and “maritime performing party” (see above, para. 131) had been followed in redrafting the text. In the revised text, “Performing party” was defined narrowly, such that subparagraph (a) detailed the inclusive list, and subparagraph (b) detailed the excluded persons, which was thought to solve the potential problem of the employee of the maritime performing party being held liable pursuant to the draft convention for the actions of its employer. In addition, it was indicated that the list of persons included in the vicarious liability provision of draft article 18 was expanded to specifically include the persons who, the Working Group had decided, should receive such protection. Further, automatic protection was specifically included for the broader category of persons, as agreed by the Working Group, and protection pursuant to draft article 4 was expanded, including small additional changes such as the inclusion of arbitral proceedings in the text of the provision. Certain technical adjustments were also made to draft article 19 (1), such as moving a portion of subparagraph 1 (a) into the chapeau. Finally, it was explained that the last sentence of the definition of “maritime performing party” was intended to exclude specifically from the definition those inland carriers who carried the goods only into or out of the port, as decided by the Working Group.

“by the carrier” in draft article 1 (6)(b)(ii)

143. It was suggested that the closing phrase, “by the carrier” in draft article 1 (6)(b)(ii) could be deleted as redundant. However, it was explained that that phrase was necessary because subparagraph (b) set out the exclusions from the definition, and subparagraph (b)(ii) specifically referred to the situation in draft article 14 (2), where a shipper or other person could agree to perform obligations normally undertaken by the carrier. In such a case, it was clarified, the draft convention should exclude from the definition those retained either directly or indirectly by cargo interests, but that since the carrier itself was also retained by the shipper, the phrase had to be included to ensure that the carrier was not excluded as a “performing party”.

“Inland carrier” in draft article 1 (7)

144. In response to concerns raised that the phrase “inland carrier” did not include carriage by inland waterway, partially due to uncertainties of translation in various language versions of the text, the Working Group affirmed that it intended to include road, rail and inland waterway transport within the term. There was support for a request that that intention be clarified in the text, and for the suggestion that the position of ferries operated by inland carriers also be clarified, perhaps more in

terms of the definition of the contract of carriage of goods by sea than as part of the definition of “maritime performing parties.”

145. In addition, it was noted that the term “inland carrier” might not be ideal, since the word “carrier” was a defined term, and it was suggested that “inland performing party” might be preferable. That suggestion was not favoured, however, as it was thought that it could inadvertently exclude from the definition of “maritime performing party” some inland performing parties who clearly should be included, such as stowage planners, who might do their work exclusively from an office located outside of a port, but who were clearly maritime performing parties.

“trans-shipment” and “port” in draft article 1 (7)

146. A question was raised regarding the exclusion of performing parties in the case of trans-shipment from the definition of “maritime performing party.” While it was acknowledged that the Working Group had agreed to such treatment, concern was raised regarding the apparent gap that such treatment created in the coverage of the draft convention. Nonetheless, the text in this regard was accepted as drafted.

147. An additional drafting point was raised with respect to the second sentence of the definition of “maritime performing party” referring to trans-shipment. It was thought that that sentence could be deleted as being covered by the closing sentence of the definition that only included in its scope inland carriers that performed services exclusively within a port area, thus excluding from the definition those involved in trans-shipment that did not perform services exclusively in a port area, but rather travelled between ports. Some support was expressed for that view, and it was suggested that such an approach could be considered in further drafting adjustments.

148. Concerns were raised, however, that in the case of very large or geographically proximate ports, or different ports that were administered under a single authority, it would be very difficult to determine whether a performing party were performing its services “exclusively within a port area”, and thus very difficult to determine who qualified as “maritime performing parties.” Support was expressed for those concerns, including some support for the suggestion that the Working Group might wish to consider excluding altogether inland carriers from operation of the draft convention. In response, it was noted that the Working Group had previously agreed to leave the determination of what constituted a “port” to local authorities and the judiciary, since views on that topic differed widely according to geographic conditions. It was also indicated that it was difficult to determine whether this would be a serious problem, and that, in any event, the draft convention had left undefined a number of terms given the inability of the instrument to answer every question. In addition, it was noted that the Hamburg Rules referred to the “port” without defining the term. Despite concerns that such an approach to determining the ambit of a particular port could result in unnecessary and expensive litigation to determine the local meaning of “port”, it was agreed that a solution such as the suggested exclusion of all inland carriers would be a policy decision that would have serious consequences throughout the draft convention. As such, the current approach taken in draft article 1 (7) was broadly supported.

Draft article 4

149. It was observed that paragraph 1 of draft article 4 should be amended through the inclusion of “arbitral proceedings” in order to render it consistent with the

additional paragraphs proposed in the revised text. In response to a question regarding the use of the phrase “that person is entitled to defences and limits of liability as provided for in this Convention” in the revised text, it was explained that a different phrase was used from that of the original text in order to clarify that where, for example, a carrier contractually agreed to increase its limitation on liability, a person referred to in draft article 4 would not be bound by that contractual agreement, but would rather be governed by the terms of the draft convention. Support was expressed for that approach, and clarification of the text in that regard was encouraged.

Various drafting issues

150. It was indicated that the definition of “performing party” included agents but excluded employees, and that in some jurisdictions, agents and employees would be treated similarly. In response to a question, it was noted that there was a duplication in draft article 18 that should be corrected, in that subparagraph (a) referred to “any performing party” and subparagraph (c) included “agents”, but that “agents” were already included in the definition of “performing party”. However, it was thought that that issue should be examined more closely, since it might still be necessary to refer to “agents of the carrier” in draft article 18. A further suggestion was made that “agents of the carrier” should be expressly included in the definition of the “performing party.”

151. In response to a question regarding the treatment of employees and agents under draft article 19 (1)(b), it was noted that the phrase “any person to which it has entrusted the performance” was intended to include such persons. However, it was agreed that should any doubt persist in that regard, the master and crew of the ship, employee and agent should be included in the text of draft article 19 (1)(b). A preference was expressed for such a clarification in the text, but a further observation was made that that inclusion should be very specific so as to ensure that it referred to the master and crew of the ship that performed the ocean transport leg for which the maritime performing party was responsible.

152. A question was also raised regarding the inclusion of independent contractors in the Himalaya protection. It was indicated that “subcontractors” were included in the definition of the “performing party” and thus were included under Himalaya protection by virtue of the inclusion of the “performing party”, but it was suggested that if that reference were unclear, consideration could be given to the addition of “independent contractors”.

Conclusions reached by the Working Group regarding the revised text

153. After discussion, the Working Group decided that:

- It was satisfied that the revised text corresponded to its earlier decisions;
- Some drafting suggestions as set out in the paragraphs above should be considered by the Secretariat, including examination of the list of persons excluded from “performing party”; the treatment of “agents” in draft article 1 (6), 4 (2) and 18; and appropriate wording to include inland waterways in the closing sentence of draft article 1 (7);
- The revised text was otherwise generally acceptable to the Working Group.

Chapter 19. Validity of contractual terms

General remarks

154. In accordance with its earlier decision to consider all provisions affecting the scope of application of the draft convention at the current session, the Working Group proceeded to consider the provisions in chapter 19 (Validity of contractual terms) of the draft convention, together with the definition of “volume contracts” (article 1, paragraph 2), once the Working Group had had sufficient time to study and consult on proposals that had been submitted by some delegations on the issue of freedom of contract under the draft convention (joint proposals by Australia and France contained in documents A/CN.9/612 and A/CN.9/WG.III/WP.88).

Draft article 88. General provisions

155. The Working Group was reminded that its most recent consideration of draft article 88 on the validity of contractual terms was at its seventeenth session (see A/CN.9/594, paras. 146 to 153). The Working Group proceeded to consider draft article 88 as contained in A/CN.9/WG.III/WP.81.

Paragraph 1

156. The Working Group was in agreement that draft paragraph 1 should be approved as drafted.

Paragraph 2

157. A suggestion was made that paragraph 2, concerning exclusions or limitations in the contract of carriage to the obligations and liabilities of shippers, should be drafted in similar fashion to paragraph 1 in order to act as a counterbalance to that provision, which concerned exclusions or limitations in the contract of carriage to the obligations and liabilities of carriers. By way of explanation regarding how a shipper's obligations might still be increased despite the fact that there was currently no limit on a shipper's liability in the draft convention, it was noted that a shipper's liability might, for example, be increased from one based on negligence to one of strict liability.

158. While there were some suggestions to delete the paragraph completely, there was agreement in the Working Group to keep the paragraph in the text and to remove the square brackets surrounding it.

159. Some doubts were raised with respect to the word “or increases” which appeared in square brackets in subparagraphs (a) and (b). If the obligations of the shipper being referred to in paragraph 2 were limited to those set out in the draft convention, it was thought that the references to “or increases” should be kept and the brackets deleted. However, if the obligations referred to additional obligations outside of the draft convention, it was said that the references to “or increases” should be deleted from the text. Since, generally speaking, the view of the Working Group was that shippers in the case of this paragraph needed greater protection, as the paragraph related to contracts of carriage other than a volume contract, there was support for the view to retain the references to “or increases” and to delete the square brackets surrounding them. However, it was thought that further consideration should be given to the possibility of confusion regarding which

obligations were being referred to, and possible adjustments should be made to the text to clarify the issue, if necessary.

Conclusions reached by the Working Group regarding draft paragraph 2

160. After discussion, the Working Group decided that:

- The text of draft paragraph 2 should be retained in the draft convention as drafted; and
- The text in square brackets “or increases” should be retained and the brackets removed.

Draft article 89. Special rules for volume contracts

161. The Working Group noted that the text that appeared in draft article 89 was the result of extensive negotiations that had taken place since the Working Group’s twelfth session (Vienna, 6-17 October 2003), and reflected, with some drafting adjustments, a compromise that had been achieved at the seventeenth session of the Working Group (New York, 3-13 April 2006).

162. There was wide support within the Working Group for the notion of freedom of contract and the need to incorporate in the draft convention provisions that took into account commercial reality, in particular the growing use of volume contracts. There was support for the view that shippers were not exposed to any significant risk of being deprived from the protection afforded by the draft convention since shippers were free to enter into volume contracts and negotiate their terms or, alternatively, to ship goods under a transport document fully covered by the draft convention. The choice between one or the other option was within each shipper’s commercial judgement. However, there was strong support for the proposition that, while generally desirable in the case of parties with equal bargaining power, unlimited freedom of contract might in other cases deprive the weaker party, typically small shippers, of any protection against unreasonable unilateral conditions imposed by carriers. It was further said that, as presently drafted, draft article 89, when read in conjunction with the definition of volume contracts in draft article 1, paragraph 2, did not afford the desirable level of protection. The Working Group was reminded that the history of the law of carriage of goods by sea was the history of the gradual introduction of mandatory rules on liability, which nowadays could be found in various international conventions regulating different modes of carriage. As the draft convention was said to be the only international instrument to contain provisions that offered considerable scope for freedom of contract, the Working Group was urged to consider proposals to remedy that situation.

163. Those proposals as contained in A/CN.9/WG.III/WP.88 and A/CN.9/612 included essentially three elements. Firstly, the definition of volume contracts in draft article 1, paragraph 2, should be amended so as to provide for a minimum period and a minimum quantity of shipments, or at least require such shipments to be “significant”. Secondly, the substantive condition for the validity of a volume contract (that is, that it should be “individually negotiated”), and the formal condition for validity of derogations (that the derogation should be “prominently” specified), as provided in draft article 89, paragraph 1, should be made cumulative, rather than alternative, so as to make it clear that both parties to the contract must expressly consent to the derogations. Thirdly, the list of matters on which no derogation was admitted, which currently included only the carrier’s obligation to keep the ship seaworthy and properly crew the ship (art. 16 (1)), and the loss of the

right to limit liability (art. 64), should be expanded so as to cover draft article 17 (basis of the carrier's liability), draft article 62 (limits of liability), draft article 30 (basis of the shipper's liability to the carrier), chapter 5 (obligations of the carrier); and draft articles 28 to 30, and 33 (obligations of the shipper). There were various expressions of support for the proposition that, even if the Working Group were not to accept all of those elements, at least a revision of the definition of volume contracts should be considered, so as to narrow down its scope of application and protect smaller shippers, in view of the potentially very wide share of international shipping that might, in practice, be covered by the current definition of volume contracts. Failure to do so, it was said, might mean that the draft convention would be devoid of practical significance.

164. At that stage, the Working Group was reminded of its past deliberations on the matter and the evolution of the treatment of freedom of contract under the draft convention. It was pointed out that special rules for volume contracts and the extent of freedom of contract that should be afforded thereunder had been under consideration by the Working Group for a number of years. Following the approach taken in previous maritime instruments, the draft convention had been originally conceived as a body of law incorporating essentially mandatory rules for all parties. Thus, the initial version of the draft convention had provided, in relevant part that "any contractual stipulation that derogates from this instrument is null and void, if and to the extent that it is intended or has as its effect, directly or indirectly, to exclude, [or] limit [, or increase] the liability for breach of any obligation of the carrier, a performing party, the shipper, the controlling party, or the consignee" (A/CN.9/WG.III/WP.21, article 17.1).

165. At the twelfth session of the Working Group (Vienna, 6-17 October 2003), however, it had been suggested that more flexibility should be given to the parties to so-called "Ocean Liner Service Agreements" in the allocation of their rights, obligations and liabilities, and that they should have the freedom to derogate from the provisions of the draft convention, under certain circumstances (A/CN.9/WG.III/WP.34, paras. 18-29). It was proposed that such freedom should be essentially granted whenever one or more shippers and one or more carriers entered into agreements providing for the transportation of a minimum volume of cargo in a series of shipments on vessels used in a liner service, and for which the shipper or shippers agreed to pay a negotiated rate and tender a minimum volume of cargo (A/CN.9/WG.III/WP.34, para. 29).

166. At that session, there was broad agreement that certain types of contracts either should not be covered by the draft instrument at all, or should be covered on a non-mandatory, default basis. It was considered that such contracts would include those that, in practice, were the subject of extensive negotiation between shippers and carriers, as opposed to transport contracts that did not require (or where commercial practices did not allow for) the same level of variation to meet individual situations. The latter generally took the form of contracts of adhesion, in the context of which parties might need the protection of mandatory law. The Working Group agreed, however, that the definition of the scope of freedom of contract and the types of contracts in which such freedom should be recognized needed further consideration (A/CN.9/544, paras. 78-82).

167. The Working Group considered a revised proposal on freedom of contract under "Ocean Liner Service Agreements" (A/CN.9/WG.III/WP.42) at its fourteenth session Working Group (Vienna, 29 November-10 December 2004). At that time, the Working Group heard a number of concerns regarding freedom of contract under

Ocean Liner Service Agreements. In particular, it was suggested that it should not be possible for parties to OLSAs to contract out of certain mandatory provisions of the draft instrument. It was also stated that the introduction of a special regime for OLSAs could create market competition-related problems. Concerns were also expressed regarding the protection of small shippers with weak bargaining power who could be subject to potential abuse by carriers through OLSAs. However, it was also said that in current trade practice, small shippers generally preferred to resort to rate agreements, which were not contracts of carriage but which guaranteed a maximum rate without specifying volume, rather than committing to volume contracts, and that the attractiveness of rate agreements combined with market forces would minimize any potential exposure to abuses by carriers under the proposed OLSA regime. Broad support was expressed for the inclusion of OLSA provisions in the draft instrument, subject to these and other concerns (A/CN.9/572, paras. 99-101). The Working Group concluded its deliberations at that stage by deciding that it was not opposed to the inclusion of a provision on OLSAs in the draft instrument, subject to the clarification of issues relating to the scope of application of the draft instrument to volume contracts generally. The Working Group further decided that particular care should be dedicated to the definition of OLSAs and to the protection of the interests of small shippers and of third parties, and that further consideration should be given to examining which provisions, if any, of the draft convention should be of mandatory application in an OLSA. Lastly, the Working Group invited the original proponents of the OLSA proposal to work with other interested delegations on refining the OLSA definition (A/CN.9/572, para. 104).

168. The Working Group reverted to the matter of freedom of contract under “Ocean Liner Service Agreements” at its fifteenth session (New York, 18-28 April 2005). The Working Group was then informed of the outcome of the consultations that had taken place pursuant to the request made at its fourteenth session. It was then suggested that since “Ocean Liner Service Agreements” were a type of volume contract, adjustments could be made to the provisions in A/CN.9/WG.III/WP.44 and to draft articles 88 and 89 in order to subsume OLSAs into the existing approach to volume contracts in the scope of application of the draft instrument. The Working Group concurred with that suggestion (A/CN.9/576, paras. 12, and 14-16). The Working Group then proceeded to consider manners of addressing the concerns that had been expressed at its earlier session, as regards the conditions under which it should be possible to derogate from the provisions of the draft convention. While a view was expressed that no derogation from the provisions of the draft convention should be allowed under any conditions, there was support for derogation to be allowed in some circumstances. The Working Group generally accepted that the following four conditions should be met before it would be possible for a volume contract, or individual shipments thereunder, to derogate from the draft instrument: (a) the contract should be [mutually negotiated and] agreed to in writing or electronically; (b) the contract should obligate the carrier to perform a specified transportation service; (c) a provision in the volume contract that provides for greater or lesser duties, rights, obligations, and liabilities should be set forth in the contract and may not be incorporated by reference from another document; and (d) the contract should not be [a carrier’s public schedule of prices and services,] a bill of lading, transport document, electronic record, or cargo receipt or similar document but the contract may incorporate such documents by reference as elements of the contract (A/CN.9/576, paras. 17-19). The Working Group proceeded to consider the question as to whether there should be mandatory

provisions of the draft convention from which derogation should never be allowed, and if so, what were they. In this respect, the Working Group decided that the seaworthiness obligation should be a mandatory provision of the draft instrument from which derogation was not allowed (A/CN.9/576, paras. 17-19).

169. The Working Group last considered the matter of volume contracts at its seventeenth session (New York, 3-13 April 2006), on the basis of a revised version of the draft convention (A/CN.9/WG.III/WP.56) and amending proposals that had been made following informal consultations (A/CN.9/WG.III/WP.61). At that session, some concerns were reiterated regarding the possible abuse of volume contracts to derogate from the provisions of the draft convention, particularly in cases where volume contracts could involve a large amount of trade. Concerns were raised that it could be seen as inconsistent to have such broad freedom of contract to derogate from a mandatory convention, and the view was expressed that a preferable approach would be instead to list specific provisions that could be subject to derogation. Another view was expressed that the combination of paragraphs 1 and 5 of draft article 95, and of the definition of volume contracts in draft article 1 had addressed earlier concerns regarding sufficient protection for the contracting parties. An additional concern was expressed that while, generally, some freedom of contract was desirable and that volume contracts as such were not necessarily objectionable, it was possible that draft paragraph (1) (b) did not provide sufficient protection for the parties to such contracts (A/CN.9/594, para. 155). Overall, however, strong support was expressed in the Working Group both for the volume contract regime in the draft convention in general, and for the redrafted text of draft paragraph 95 (1) as it appeared in paragraph 49 of A/CN.9/WG.III/WP.61. The view was expressed that the volume contract framework provided an appropriate balance between necessary commercial flexibility to derogate from the draft convention in certain situations, while nonetheless providing adequate protection for contracting parties (A/CN.9/594, para. 156). The Working Group next considered the issue of whether it was desirable to include in the volume contract regime of the draft convention a provision containing a list of absolutely mandatory provisions from which there could be no derogation regardless of any agreement, such as that set out in draft paragraph 95 (4) in paragraph 49 of A/CN.9/WG.III/WP.61. Some concern was raised regarding the inclusion of such a provision in the draft convention, since it was felt that it could be used in the later interpretation of the draft convention to reintroduce the notion of overriding obligations that had been carefully avoided in the drafting of the provisions. However, strong support was expressed for the inclusion of a provision listing the mandatory provisions from which there could never be derogation pursuant to the volume contract regime in the draft convention. It was felt that including a provision such as draft paragraph 95 (4) was an important part of the overall compromise intended to provide sufficient protection for contracting parties under the volume contract framework (A/CN.9/594, para. 160). As regards which provisions should be included in such a list, it was agreed that all of the references in the then draft paragraph 95 (4) as set out in A/CN.9/WG.III/WP.61 should be kept in the text (A/CN.9/594, para. 161).

170. The text that appeared in draft article 89, therefore, was said to be the result of a carefully crafted compromise that had involved extensive negotiations over a number of sessions of the Working Group. There were several expressions of sympathy for the concerns that had been expressed in connection with the treatment of freedom of contract under the draft convention. However, the prevailing view within the Working Group was that the current text of draft article 89 reflected the best possible consensus solution to address those concerns in a manner that

preserved a practical and commercially meaningful role for party autonomy in volume contracts. There was wide agreement within the Working Group that it would be highly unlikely that the Working Group would be in a position to build an equally satisfactory consensus around a different solution, and the Working Group was strongly urged not to make attempts in that direction at such a late stage of its deliberations.

171. It was also noted that a number of delegations that currently advised against revisiting draft article 89 had shared at least some of those concerns and had been originally inclined towards a stricter regime for freedom of contract. While those delegations did not regard draft article 89 in all respects as an ideal solution, it was said that their major concern, namely the protection of third parties, had been satisfactorily addressed by the provisions of paragraph 5 of the draft article. Furthermore, the use of the words “series of shipments” in the definition of volume contracts in draft article 1, paragraph 2, provided additional protection against the risk of unilateral imposition of standard derogations from the draft convention, since occasional or isolated shipments would not qualify as “volume contract” under the draft convention.

Conclusions reached by the Working Group regarding draft article 89

172. After extensive consideration of the various views expressed, the Working Group rejected the proposal to reopen the previously-agreed compromise and approved the text of draft article 89 that had previously been accepted in April 2006 (see A/CN.9/594, paras. 154 to 170).

Draft article 90. Special rules for live animals and certain other goods

173. The Working Group was reminded that its most recent consideration of draft article 90 on special rules for live animals and certain other goods was at its seventeenth session (see A/CN.594, paras. 171 to 172). The Working Group proceeded to consider draft article 90 as contained in A/CN.9/WG.III/WP.81.

Chapeau and subparagraph (a)

174. The Working Group was in agreement that the chapeau and draft subparagraph (a) should be approved as drafted, bearing in mind that adjustments might need to be made to the text following the Working Group’s reconsideration of the definitions of “performing party” and “maritime performing party”.

Subparagraph (b)

175. The Working Group took note of the proposal set out in A/CN.9/WG.III/WP.90 that, to combat alleged abuses that considered containers or road vehicles “non-ordinary shipments” in order to have the container or road vehicle considered to be a single unit for the purposes of limiting liability, the following sentence should be added to the end of the subparagraph: “The containers or road vehicles, whose transport is made by a ship entirely or partially equipped to undertake such transport, cannot be considered as ‘non-ordinary commercial shipments’.” The view was expressed that such an addition was unnecessary, since clauses of that type usually appeared in some short sea voyages, such as ferry carriage, in respect of which carriers typically issued sea waybills rather than bills of lading which would trigger the Hague and Hague-Visby Rules. However, it was expected that the

contract of carriage applicable in such a case would trigger the draft convention, whose provisions would eliminate such an abuse.

176. The Working Group was in agreement that draft subparagraph (b) should be approved as drafted.

Liability for delay in delivery of the goods

177. The Working Group was reminded that its most recent consideration of liability for delay in the delivery of goods pursuant to the draft convention had taken place in the context of shipper's liability for delay, which had been last considered at its eighteenth session (see A/CN.9/616, paras. 83 to 113). It was also recalled that two proposals with respect to liability for delay had been submitted to the Working Group for consideration: a proposal on delay prepared in light of the consideration of the topic during its eighteenth session (A/CN.9/WG.III/WP.85) and a proposal on carrier and shipper delay (A/CN.9/WG.III/WP.91). The Working Group proceeded to consider the various provisions concerning delay as contained in A/CN.9/WG.III/WP.81.

General introduction

178. The Working Group was reminded that it had considered the topic of liability for delay in the delivery of goods during a number of its sessions, and that the topic was one of particular sensitivity on the part of both shippers and carriers. Given the thoroughness of previous discussions on the topic, it was thought that a complete review of the issues involved and the carrier and shipper interests at stake was unnecessary, and discussion proceeded to various proposals that had been placed before the Working Group. It was explained that the proposal contained in A/CN.9/WG.III/WP.85 was a written version of what had been proposed orally during the eighteenth session of the Working Group (A/CN.9/616, paras. 101-113), which, it was recalled, had been an attempt by the Working Group to retain in the draft convention liability for delay on the part of both the carrier and the shipper, and to find an appropriate limitation level for shipper's liability for delay. In light of that, the proposal was said to be a compromise that contained three elements: a clarification of draft article 18 that the carrier was not liable for any loss or damage to the extent that it was attributable to other shippers; the limitation of shipper's liability for pure economic loss arising from delay to an amount that was in square brackets in the text; and a general rule on causation to be placed in draft article 22.

179. The Working Group was reminded that its deliberations on damages for delay were concerned with pure economic loss resulting from delay, since physical damage to the goods resulting from delay would be covered by the draft convention under its provisions on liability for loss of or damage to the goods. Further, it was indicated that research undertaken on the topic had found very few reported cases, and no successful cases, in jurisdictions that allowed for the recovery of damages for delay. While some doubt was expressed regarding the reason for so few cases on the topic, a view was expressed that the findings suggested that there was no commercial need for delay provisions, and it was said that, in any event, they should be non-mandatory. More specific arguments were put forward in support of the view that liability for delay should be non-mandatory, as set out in A/CN.9/WG.III/WP.91. Although it was said that the deletion of liability for delay on the part of both the shipper and the carrier was the best option in light of

commercial reality and the apparent difficulty in finding an acceptable way to limit the liability of the shipper for damages due to delay, an alternative proposal set out in A/CN.9/WG.III/WP.91 was to make shipper's and carrier's liability for delay non-mandatory, or subject to freedom of contract. However, concerns were raised that this approach would simply result in carriers inserting standard language in the transport document exempting them from liability for any damages due to delay.

Discussion

180. The Working Group was informed that the working hypothesis for a compromise on the issue of delay that had been proposed during its eighteenth session, and that was embodied in A/CN.9/WG.III/WP.85, had not met with sufficient support in further formal and informal consultations, and that it was in danger of failing. In light of that possibility, a number of other proposals were made regarding how best to deal with the issue of liability for delay in the draft convention. Those proposals could be summarized as follows:

(a) All reference to liability for delay on the part of the shipper and on the part of the carrier should be deleted from the text of the draft convention, thus leaving the determination of such matters to national law;

(b) A more elaborate proposal consisted of three elements. First, the shipper's liability for delay should be deleted due to failure to find a suitable means to limit that liability. Secondly, the text of draft article 21 on delay should be limited to the opening phrase ("Delay in delivery occurs when the goods are not delivered at the place of destination provided for in the contract of carriage within the time expressly agreed") and the rest of the draft article should be deleted. Thirdly, draft article 63 should be made mandatory by deletion of the phrase in square brackets "unless otherwise agreed";

(c) The limitation of liability for economic loss caused by delay should be made subject to freedom of contract by retaining the text in square brackets in draft article 63 and removing the brackets;

(d) Liability for delay should be made non-mandatory, or subject to freedom of contract, in regard to both the carrier and the shipper;

(e) The text with respect to the recoverability of damages as proposed during the eighteenth session of the Working Group (see para. 107, A/CN.9/616) should be reintroduced in addition to the proposal set out in A/CN.9/WG.III/WP.85;

(f) Shipper's liability for delay should be excluded from the draft convention, and carrier liability for delay should only be maintained in the case where the shipper made clear to the carrier its interest in timely delivery;

(g) Liability for delay should be mandatory on the part of the carrier, but more flexible with respect to shippers;

(h) The treatment of both the carrier and the shipper should be identical with respect to liability for damages for delay;

(i) A provision should be included that made clear that compensation for economic loss that was not connected to any physical damage should be excluded from the draft convention in the case of both the shipper and the carrier;

(j) Liability for delay should be mandatory on the part of both the shipper and the carrier; and

(k) The same approach to delay should be taken as was adopted in the Hamburg Rules, including the limitation level of two and one half times the freight payable for the goods delayed.

181. The Working Group heard a number of views on which of the proposals set out in the previous paragraph were preferred, and which could be considered as second and third choices. In the course of that discussion, while no clear consensus for any one of the approaches set out above initially emerged in the Working Group, a number of strongly held positions were enunciated and received support in the Working Group. These may be summarized as:

(a) There appeared to be general agreement that the compromise articulated in A/CN.9/WG.III/WP.85 would not achieve acceptance in the Working Group;

(b) There was strong support for the retention of liability on the part of the carrier for damages arising due to delay;

(c) There was support for the view that liability for delay on the part of the carrier should be mandatory; and

(d) There was a high degree of flexibility regarding the necessity of including liability on the part of shippers for damages due to delay, particularly given information provided to the Working Group on the difficulty and expense involved for shippers insuring for pure economic loss.

182. In light of the strong views expressed, the Working Group sought to reach a compromise on the issue by focussing on the first two alternative approaches set out in paragraph 180 above. It was stated that one of the advantages of deleting liability for delay for both the shipper and the carrier from the draft convention was to give greater flexibility to jurisdictions that had specific rules on carrier delay. In addition, the view was expressed that it was better to have no rule on liability for delay in the draft convention than to formulate one that was inadequate or detrimental to the operation of mandatory domestic law. The countervailing view was that the three-pronged proposal would allow for at least a certain level of harmonization with respect to the rules on delay, rather than leaving the entire matter to domestic law. Furthermore, a compromise solution that limited the notion of delay to a failure to deliver the goods within the agreed delivery period would fit well with a commercial approach that had been advocated to the problem of liability for delay.

183. While a general preference appeared to emerge in favour of the three-pronged proposal described in paragraph 180 (b) above, the Working Group heard conflicting views on the desirability of deleting the clause in draft article 21 that referred to the time within which it would be reasonable to expect that a diligent carrier would deliver the goods, having regard to the terms of the contract, the customs, practices and usages of the trade, and the circumstances of the journey. There was strong support for retaining those words, which were said to be the core of the draft article and to offer an important safeguard to protect shippers from unreasonable delay by carriers. Shippers, it was stated, should not only be entitled to damages for delay when carriers failed to deliver by an expressly agreed date. Shippers deserved the same protection when they relied on advertisements and line schedules published by carriers. However, there was also strong support for deleting the words in question, which were said to express a vague concept of difficult application that was likely to increase the risk of litigation.

184. At that stage, the Working Group was invited to consider an amended version of the three-pronged approach set out in paragraph 180 (b) above. The Working Group was reminded that the first option for several delegations was to have mandatory rules on carrier delay in the draft convention, failing which they would prefer the deletion of all references to liability for delay from the text of the draft convention, thus leaving the determination of such matters to domestic law. The proponents of that solution were however prepared to accept the three-pronged approach set out in paragraph 180 (b) above, subject to the deletion of the word “expressly” from the description of delay enunciated in draft article 21. Such an adjustment, it was said, would render the deletion of the latter half of the draft provision less problematic for many in the Working Group, and reduce the burden of proof on cargo claimants regarding agreement on the time of delivery. Others were of the view, however, that deletion of the word “expressly” would not substantively alter the provision. In the spirit of compromise, the Working Group welcomed that proposal and supported the three-pronged approach as amended by it.

Draft article 26. Carriage preceding or subsequent to sea carriage

185. The Working Group was reminded that draft article 26 had been last considered at its eighteenth session (see A/CN.9/616, paras. 216 to 228). The Working Group proceeded to consider draft article 26 on carriage preceding or subsequent to sea carriage as contained in A/CN.9/WG.III/WP.81.

186. In respect of draft article 26 generally, the Working Group was reminded that a proposal had been made suggesting a consolidated text for draft articles 26, 64 (2) and the former draft article 89 as it appeared in A/CN.9/WG.III/WP.56 (see A/CN.9/WG.III/WP.89). It was suggested that the close connection between those draft provisions in terms of regulating the relationship of the draft convention with other conventions made it desirable to consolidate them into a single provision that would be clearer and more reader-friendly. The Working Group, however, preferred to continue treating those provisions separately and did not take up that proposal.

Paragraph 1

“*[or national law]*”

187. Some support was expressed for a retention of the bracketed text “or national law” in draft paragraph 1. In that respect, it was said that the contract of carriage under a “maritime plus” regime such as that envisaged pursuant to the draft convention, might contain a very long inland leg and a comparatively short sea leg. In that context, it was said that a reference to national law in draft article 26 was necessary in some jurisdictions to preserve mandatory national law that applied in respect of the inland transport. In further support of maintaining the references to national law in draft paragraph 1, it was suggested that with that reference non-maritime performing parties would have greater certainty that they did not fall within the liability regime of the draft convention. Further, in response to suggestions that the inclusion of the reference to mandatory national law strayed too far from the draft convention’s goal of uniformity, it was pointed out that the inclusion of “international instruments” in paragraph 1 already provided for the possible inclusion of regional international agreements, which could simply consist of an exchange of notes between two States.

188. However, strong support was shown for the deletion of the phrase “or national law” as currently found in square brackets in draft paragraph 1. Although there was sympathy for those who sought a solution for the problems outlined in the previous paragraph, it was said that the retention of references to national law represent a major departure from the balance that had already been achieved on the network approach as contained in draft article 26, paragraph 1. It was further said that there had been an understanding that in formulating a basis for the network system, it had not been possible to reach complete uniformity due to the need to accommodate in certain limited situations the operation of other unimodal conventions such as the Convention on the Contract for the International Carriage of Goods by Road (CMR) and the Uniform Rules concerning the Contract for International Carriage of Goods by Rail (CIM-COTIF). However, it was said that the expansion of those narrow exceptions to include all mandatory national law would undermine the usefulness of the entire provision and would greatly detract from the uniformity and predictability of the draft convention as a whole. In addition, it was suggested that the inclusion of a reference to national law in article 26, paragraph 1 could render it impossible to use draft article 4 (“the Himalaya clause”) to protect performing parties. Another problem with the inclusion of a reference to national law was said to be that it would create uncertainty for both shippers and carriers in terms of determining which liability regime would govern their activities.

The compromise proposal

189. In light of the support within the Working Group in favour of both retaining and of deleting the phrase “or national law” in paragraph 1, a compromise proposal was suggested. The proposal was to allow Contracting States that wished to apply their mandatory national law to inland cases of loss of or damage to the goods to do so by means of declarations made in accordance with draft article 94. It was envisaged that Contracting States should be required to identify specifically the national law that would apply in those cases. The effect of such a declaration would be to allow the courts of that State to apply national law to cases of localized inland damage in that State. However, courts of other States than the State making the declaration would not be bound by that declaration, and would apply the text of the draft convention according to its terms, and without regard to mandatory national law. Furthermore, it was clarified that courts of the State making the declaration would only be able to apply their substantive national law with respect to damage occurring within that State, and that the declaration would not provide a basis for any purported extraterritorial effect of the national law in cases of inland loss or damage outside of that State.

190. While strong preferences were expressed in the Working Group for both retaining and deleting the references to national law, broad support was expressed for the compromise proposal. While the inclusion of national law in draft article 26, even if by way of declaration rather than in the text itself, was said to detract from the uniformity of the draft convention, it was noted that at least the specification of only certain national laws by specific countries making declarations to that effect would allow for greater uniformity and predictability than including reference in the text to the national law of all Contracting States. Further, such an approach allowed for the accommodation of the needs of certain States who had mandatory national provisions regarding their inland carriage. The Working Group was reminded that such an approach had been advocated in A/CN.9/WG.III/WP.23. In light of the technical nature of formulating the appropriate approach to the declaration technique, the Working Group agreed not to consider specific proposals to that

effect at the present stage and requested the Secretariat to offer draft language in due course. The Working Group took note of the view that if the declaration approach were adopted by the Working Group as a compromise solution, part of the compromise should be the deletion of the phrase “or national law” in draft article 62 (2) on non-localized damage, if draft article 62 (2), which was in square brackets, were retained in the text.

Variant A or B

191. While support was expressed in the Working Group for the retention of Variant A of subparagraph 1 (a), a stronger preference was expressed for Variant B as being clearer and more likely to be interpreted accurately. It was further said that the text of Variant B was preferable in that it ensured that the operation of the draft convention would take place independently of the scope provisions of other transport conventions. Variant A, it was suggested, was less desirable, since it was drafted as primarily a conflict of conventions provision that relied upon the interpretation of the scope provisions of other transport conventions.

Conclusions reached by the Working Group regarding paragraph 1

192. The Working Group was in agreement that:

- All references to the phrase “[or national law]” should be deleted from paragraph 1;
- The Secretariat should draft a declaration provision allowing a Contracting State to include in draft article 26 (1) its mandatory national law provided that: (1) the State specifically identified in a declaration to that effect made pursuant to draft article 94; (2) the national law of the State making the declaration applied to the loss or damage in question; and (3) the damage occurred in the territory of the State that made the declaration; and
- Variant B of draft subparagraph 1 (a) should be taken up and Variant A deleted.

Paragraph 2

193. It was observed that draft paragraph 2 of article 26 referred to draft article 62 (2), and it was suggested that discussion of draft article 26 (2) should be deferred until the Working Group had considered draft article 62 (2). That suggestion was approved by the Working Group in light of the relationship between draft article 26 on localized damage to the goods and draft article 62 (2) on non-localized damage to the goods. However, it was also suggested that draft article 62 (2) could not be considered until a decision regarding the limitation level in draft article 62 (1) had been made was not taken up in light of the link regarding the scope of the draft convention shared by draft articles 26 and 62 (2).

Paragraph 2 of draft article 62 (2) regarding the limits of liability

194. The Working Group proceeded to consider the text of paragraph 2 of draft article 62 as found in A/CN.9/WG.III/WP.81.

195. Strong support was expressed for the deletion of draft paragraph 2 in its entirety. The view was expressed that the provision in issue was ambiguous and that it had no place in a “maritime plus” convention. In support of that view, it was said

that it was important to recall that the subject matter of the provision was non-localized damage to the goods. Since by definition, it would be unknown during which leg of the transport the damage occurred, only the contracting carrier could be held liable for such damage, and not the performing party. A provision such as draft paragraph 2 was said to undermine the very purpose of adopting an international convention. It was argued, in that connection, that although a limit on the liability of the carrier had not been settled upon, it surmised from previous discussions (see A/CN.9/616, paras. 162 to 174) that in the majority of cases, the limit would be sufficient to cover the damage to any goods, even particularly valuable goods, based on the per package limitation rate. The only result of a provision such as paragraph 2, it was said, would be to undermine the application of the per package limitation amounts in the draft convention by substituting the lesser per kilogram limitation under other transport conventions such as the CMR or CIM COTIF. Further, since only the contracting carrier would be held liable for non-localized damage, it was said that there was no logical explanation for the approach suggested in paragraph 2.

196. In addition to arguments raised in favour of the compensation rates of the per package rule in the draft convention (for both sides of the discussion, see, in general, A/CN.9/616, paras. 162 to 174) and for the suggestion that draft paragraph 2 should therefore be deleted, problems were indicated regarding the operation of the draft provision. In particular, it was said that where the damage could be said to occur during two legs of the transport, as for example, in the case of perishable goods in a container that was not properly refrigerated, it was not possible to determine whether draft paragraph 2 should apply. It was also noted that it would often be difficult to determine which transport regime offered the higher limitation amount, since the decision would entail a comparison of per package and per kilogram limitation rates, and, it was said, for goods weighing less than 82 kilograms per package, the per package limitation amount in the draft convention would always result in a higher limitation amount. Further complications were indicated with respect to the intended operation of draft paragraph 2, including difficulty regarding how to decide whether a limit on liability was unbreakable and with respect to the general increase in uncertainty and a need for litigation that it was said paragraph 2 would cause. It was also suggested that draft paragraph 2 was inconsistent with the burden of proof regime under draft article 26.

197. In response, strong support was also expressed for retaining the text of draft paragraph 2, at least in square brackets, until the Working Group had decided on what the limitation level in draft paragraph 1 would be. It was pointed out that the low limitation rate of the Hague-Visby Rules might not be considered sufficient in the case of, for example, heavy machinery cargo, which would not be subject to the per package rule, but would rather benefit from the higher per kilogram rates of the other transport conventions.

198. Views were also expressed regarding what aspects the text should contain, if it were kept. Amongst those that favoured retaining the text of draft paragraph 2, at least in square brackets, there was a preference expressed for Variant A of the draft provision as being more clearly drafted. In terms of the phrase “[or national law]”, there was support both for its retention and its deletion.

199. Further, there was support in the Working Group for the view that, in spite of the arguments for and against retaining draft paragraph 2, the clearest solution to the problem would be to have a suitable limitation on liability in paragraph 1 of draft article 62 apply in the case of all non-localized damage to goods. In such a situation,

there was support in the Working Group for the view that draft paragraph 2 could be deleted. In light of that view, it was suggested that draft paragraph 2 should be retained in square brackets pending a decision on paragraph 1 of draft article 62. However, the Working Group was also reminded that for some, the compromise reached regarding the disposition of the phrase “or national law” in draft article 26 (1) was closely tied to the disposition of draft article 62 (2), particularly with respect to deletion of the phrases “or national law”, and it was suggested that draft article 26 (1) should also be placed in square brackets pending the disposition of draft article 62 (2).

Conclusions reached by the Working Group regarding paragraph 2 of draft article 62

200. The Working Group recognized the broadly prevailing preference for the deletion of draft article 62 (2) but decided to retain the text in square brackets as it appeared in A/CN.9/WG.III/WP.81.

Paragraph 3 of draft article 26

201. The Working Group next considered the text of paragraph 3 of draft article 26 as found in A/CN.9/WG.III/WP.81. It was observed that draft paragraph 3 was intended to clarify that no deviation could be made from draft article 26 except by choice of law, and that notwithstanding paragraph 1 of draft article 26, the normal liability rules of the draft convention would continue to apply. While there was some doubt regarding the necessity of including a provision such as paragraph 3, support was expressed for the additional clarity that it lent the application of the general liability rules in the draft convention.

“maritime performing party”

202. A question was raised regarding whether it was necessary to refer to the maritime performing party in the text of draft paragraph 3, since the focus of draft article 26 was on the contract of carriage, and should thus perhaps be limited to a reference to the carrier. Some doubt was expressed regarding this view, however, and it was agreed that the concern regarding the inclusion of the maritime performing party would be noted.

Conclusions reached by the Working Group regarding paragraph 3

203. The Working Group agreed that:

- The square brackets around the text of draft paragraph 3 should be deleted and the text of the provision retained; and
- The Secretariat examine the need for referring to the maritime performing party in the draft paragraph and make proposals to the Working Group in due course.

Draft article 84. International conventions governing the carriage of goods by air

204. In keeping with its discussion of matters involving the relationship of the draft convention with other transport conventions as determined by the operation of draft article 26, the Working Group next considered a provision that had been added to the text of the draft convention following its most recent consideration of those issues during its eighteenth session (see A/CN.9/616, paras. 216 to 235). It was recalled that at that session, the Working Group had requested that a provision be

proposed in the draft convention in order to ensure that it would not conflict with the Montreal Convention (see A/CN.9/616, paras. 225 and 234 to 235). Draft article 84, as it appeared in A/CN.9/WG.III/WP.81 was intended to respond to that request.

205. To the extent that conventions such as the CMR also contained a certain multimodal dimension, the question was raised whether other unimodal transport conventions in addition to the Montreal and Warsaw Conventions should be mentioned in the provision in order to ensure that conflicts were not encountered with those conventions. In response, it was noted that the Working Group had considered the issue at its eighteenth session, and that it had decided to include in the draft convention text like that found in draft article 84 only with respect to the Montreal and Warsaw Conventions, which were unique in their intention to include multimodal transport to such an extent that a conflict between those conventions and the draft convention was inevitable. There was support for retaining draft article 84 as it appeared in the text.

Conclusions reached by the Working Group regarding draft article 84

206. The Working Group was in agreement that draft article 84 should be approved as drafted.

Chapter 8. Obligations of the shipper to the carrier

Draft article 27. Delivery for carriage

207. The Working Group was reminded that its most recent consideration of draft article 27 on delivery for carriage was at its sixteenth session (see A/CN.9/591, paras. 109 to 120). The Working Group proceeded to consider draft article 27 as contained in A/CN.9/WG.III/WP.81.

Paragraph 1

208. The Working Group was in agreement that draft paragraph 1 should be approved as drafted.

Paragraph 2

209. Although there was some support for the deletion of the provision, there was general agreement in the Working Group that draft paragraph 2 should be retained in the text of the draft convention and the square brackets around it removed.

210. It was indicated that reference was made in draft article 14 (2) to parties other than the shipper, such as the person referred to in article 34, the controlling party, and the consignee, and it was suggested that, in addition to the shipper's obligation, there should also be an obligation in paragraph 2 on those parties to properly and carefully carry out such tasks as they are performed. In any event, it was noted that all of the tasks set out in paragraph 2 were unlikely to be performed by the shipper, such as discharge, and it was suggested that there should be alignment between the wording of draft article 14 (2) and paragraph 2. One remedy suggested was that a phrase be added along the lines of "tasks that the shipper performs or causes to be performed". It was further indicated that draft article 34 (1) on the liability of the shipper for other persons was also unclear, which added to the problem. In that regard, it was suggested that if draft article 34 (1) included the shipper's liability for

the consignee and the controlling party, paragraph 2 could remain the same, but that if draft article 34 (1) did not include the consignee and the controlling party, those parties should be included in draft paragraph 2. There was support both for that view and for the view that the draft provision should remain as drafted and should be limited to the shipper's obligations, since draft article 14 (2) referred to an agreement between the shipper and the carrier for the performance of those tasks by a person other than the carrier, and it was proper that any liability that might arise in the performance of those tasks should lie with the shipper.

211. The view was expressed that the wording of draft paragraph 2 was imprecise in that the entire list of tasks set out therein did not need to be performed properly and carefully by the shipper, but instead only those tasks agreed to pursuant to draft article 14 (2). It was suggested that the list of tasks should be qualified through the addition of the phrase "as agreed" or "in accordance with the agreement". There was support for that suggestion, although other views were expressed that the use of the word "or" made the intention of the draft provision sufficiently clear without any additional text.

Conclusions reached by the Working Group regarding draft paragraph 2

212. After discussion, the Working Group decided that:

- The text of draft paragraph 2 should be retained in the draft convention as drafted and the square brackets removed;
- Regard should be had to whether the text of draft paragraph 2 should be aligned with that of draft articles 14 (2) and 34 (1) particularly in terms of the inclusion of the consignee and the controlling party; and
- The text of draft paragraph 2 could be clarified through the addition of a phrase such as "as agreed".

Paragraph 3

213. The Working Group was in agreement that draft paragraph 3 should be approved as drafted.

Draft article 28. Obligations of the shipper and the carrier to provide information and instructions

214. The Working Group was reminded that its most recent consideration of the previous text on which draft article 28 on the obligations of the shipper and the carrier to provide information and instructions was based was at its seventeenth session (see A/CN.9/594, paras. 175 to 186). The Working Group proceeded to consider draft article 28 as contained in A/CN.9/WG.III/WP.81.

215. It was indicated that the title of the draft article, which in substance concerned mutual cooperation between the carrier and the shipper, was rather close to that of draft article 29, which concerned shipper's obligations, and it was suggested that a different title for draft article 28 might be preferable so as to avoid confusion and to indicate its status as something less than an obligation of the shipper. The Working Group approved the content of draft article 28.

Conclusions reached by the Working Group regarding draft article 28

216. After discussion, the Working Group decided that:

- The text of draft article 28 was approved, with any necessary adjustments to the title.

Draft article 29. Shipper's obligations to provide information, instructions and documents

217. The Working Group was reminded that its most recent consideration of the previous text on which draft article 29 on the shipper's obligations to provide information, instructions and documents was at its seventeenth session (see A/CN.9/594, paras. 187 to 194). The Working Group proceeded to consider draft article 29 as contained in A/CN.9/WG.III/WP.81.

Paragraph 1

218. In reference to footnote 97 of A/CN.9/WG.III/WP.81, the suggestion was made to delete the word "reasonably" as it appeared before the word "necessary" in the chapeau of draft paragraph 1 for the reason that it was said to be redundant. Further, the view was expressed that the obligation to provide information, instructions and documents was an important shipper's obligation that should not in any way be qualified. However, the Working Group was in agreement that the draft paragraph should be approved as drafted.

Paragraph 2

219. The Working Group was in agreement that draft paragraph 2 should be approved as drafted.

Draft article 30. Basis of shipper's liability to the carrier**Paragraph 1**

220. The Working Group was reminded that it had most recently considered the basis of shipper's liability to the carrier at its seventeenth session (see A/CN.9/594, paras. 199-207) and earlier at its sixteenth session (see A/CN.9/591, paras. 136-153).

221. The Working Group was also reminded that it had decided that the liability for breach of the shipper's obligations should be generally fault-based with an ordinary burden of proof (see A/CN.9/591, para. 138). Thus, once a carrier had proved loss or damage was caused by the breach of obligations or negligence of the shipper, the shipper could seek to prove that the loss or damage was not due to its fault.

Variant A or B

222. It was noted that Variant A expressly placed the burden of proof on the carrier to show that the loss or damage was caused by the goods or by a breach of the shipper's obligations under draft articles 27 and 29, subparagraphs 1 (a) and (b). By contrast, Variant B focussed on shipper liability for loss, damage or delay caused by the breach of its obligations under draft articles 27 or 29 provided such loss, damage or delay was due to the fault of the shipper. It was further noted that the second sentence, which relieved the shipper of all or part of its liability if it proved that the cause or one of the causes was not attributable to its fault or to the fault of any

person referred to in draft article 34, was intended to apply regardless of which of the two variants was ultimately chosen.

223. Some support was expressed for Variant A for the reason that it appeared to implement the earlier decision of the Working Group that shipper liability should be based on fault and expressly imposed the burden of proof on the carrier.

224. However, support was also expressed for Variant B for the reason that it was a clearer expression that shipper liability was fault-based within a contractual relationship. It was said that Variant B was preferable as it expressly set out the responsibility of the shipper and indicated that the carrier bore the onus of proving that the shipper had breached its obligations and that there was a link of causation between the breach and the loss or damage.

225. Some delegations indicated that Variant B would be acceptable provided that the second sentence of paragraph 1 were deleted. It was said that that sentence created confusion as to the fault-based nature of shipper liability and also cast uncertainty on the principle that the carrier bore the burden of proof in respect of a breach of shipper obligations. Concern was expressed that that sentence appeared to require a shipper to prove that it was not at fault which might lead to the situation that draft article 30 contradicted draft article 17 which dealt with carrier liability. For example, if two or more containers came loose and damaged the ship, the cause of damage could be due to the carrier's failure to load the goods on board correctly or the result of the shipper not having packed the goods in the containers correctly. It was said that, applying the second sentence, if a carrier sued the shipper, the shipper would have the burden of proof to show what occurred on board which would in practice be very difficult. For that reason, it was proposed that shipper liability, contained in draft article 30, should not exactly mirror carrier liability in draft article 17, which merely required that claimants prove that the loss, damage or delay occurred during the period of responsibility of the carrier. It was said that shipper liability should instead be based on fault based on ordinary principles of burden of proof that the shipper was at fault. It was also said that article 30 ought to regulate shipper liability for breach of its obligations due to fault and should not try to regulate who had the burden of proof.

226. In response, it was explained that the second sentence of paragraph 1 was not intended to reverse the burden of proof but rather to set out the position that applied in most legal systems that, once the carrier had discharged its burden of proof in relation to the breach of an obligation by the shipper, the shipper could, except in respect of obligations for which it had strict liability under draft articles 31 and 32, nevertheless bring proof to show that the loss or damage or delay was not attributable to its fault or to the fault of any person referred to in draft article 34.

227. Following that explanation, some support was expressed for variant B provided it was reformulated so as to clarify that the burden of proof lay on the carrier. It was noted that the confusion in respect of burden of proof that applied in draft article 30 had arisen because it had generally been referred to as an ordinary burden of proof as if it involved a case in tort, when in fact the article referred to a contractual cause of action. It was noted that that problem did not arise in some jurisdictions which classified the cause of action for delay as neither a claim in tort or contract but rather as a statutory claim. Given the potential for misunderstanding, it was said that paragraph 1 of draft article 30 should be reformulated to clarify the nature of the burden of proof and the standards that applied thereto.

228. However, some support was expressed for a reformulation of paragraph 1 to provide a straightforward rule of negligence that the carrier prove the fault of the shipper. It was said that neither variant appeared to make clear that the carrier be required to prove the loss was caused by the shipper and that the shipper could be relieved of liability where it showed that it was not at fault. On that basis, an alternative text to Variants A and B was proposed in the following terms: “Subject to the provisions of articles 31 and 32, the shipper is liable to the carrier for loss or damage caused by the breach of its obligations pursuant to article 27 and article 29, unless the shipper proves that the cause or one of the causes of the loss or damage is not attributable to its fault or to the fault of any person referred to in article 34”.

229. Some reservations were expressed to that formulation for the reason that it did not appear to emphasize the fault-based liability of the shipper. However, the proposal also received some support for the reasons that: it clarified that the burden of proof was in relation to contractual obligations; it indicated that the liability was fault-based such that the obligations of the shipper under articles 27 and 29 were “best efforts” obligations; and it also clarified that first the carrier was to prove the breach, damage and the causation between the two, and it was then for the shipper to show that it was not at fault.

230. It was suggested that, given that the Working Group had generally reached consensus on the nature of the shipper liability provision, the reformulation could be left to the Secretariat. A proposal was made that such a reformulation could be in the following terms: “Subject to the provisions of articles 31 and 32, the shipper is liable to the carrier for loss or damage proved by the carrier to be the result of a breach by the shipper of its obligations pursuant to articles 27 and 29, unless the shipper proves that the cause or one of the causes of the loss or damage was not attributable to its fault or to the fault of any person referred to in article 34”. Some support was expressed for that reformulation although it was suggested that it be modified to indicate that the carrier must not only prove the loss or damage but also that the shipper was in breach of its obligations. It was also suggested that the text might be improved if the questions of fault-based liability and strict liability contained in draft articles 31 and 32 were separated out into two separate sentences.

Reference to article 31 in second sentence of draft article 30, paragraph 1

231. A question was raised whether the reference in the second sentence to article 31 was correct. In that respect it was noted that draft article 31 contained an obligation on the shipper to provide accurate information in a timely manner (paragraph 1) and to guarantee the accuracy of that information (paragraph 2). It was said that strict liability that applied under the second sentence of draft article 30, paragraph 1 should apply only to paragraph 2 of draft article 31 and not to paragraph 1, given that the obligation to provide information in a timely manner should be subject to fault-based rather than strict liability. That proposal received some support.

“was caused by the goods”

232. It was questioned why it was necessary to include the expression “was caused by the goods” in variant A. Some support was expressed for inclusion of the term regardless which variant was chosen to cover situations where the damage was clearly caused by the goods. However, some concern was expressed that the term might be confusing under some systems of law. It was suggested that the formulation of the text seemed to place an obligation of result and not of means on

the shipper. It was said that the inclusion of the term was illogical given that goods did not have a life of their own and could not, of themselves cause loss or damage. It was said that the words were also unnecessary given the obligations on the shipper to, inter alia, load the goods so that they would not cause harm to persons or property as set out in article 27, paragraph 1.

Delay

233. Given the Working Group's earlier decision that carrier liability for delay should be limited to situations where the carrier had agreed to deliver the goods within a certain time (see paras. 180 to 184 above) it was suggested that, as a matter of fairness, a shipper should only be liable for delay if it had so agreed. It was said that that approach would create fairness as between the carrier and shipper.

234. It was reiterated that the Working Group had decided to delete all references to delay. However, it was noted that mere deletion of all references to delay might not be sufficient to remove the possibility of delay being implied given that the term "loss" as used in both variants, could be interpreted to encompass loss caused by delay. As well, concern was expressed that deletion of all references to delay should not be interpreted as exonerating the shipper from any cause of action for delay that might arise under applicable national law.

235. To avoid any interpretation of implied liability for delay and ensure the preservation of applicable law on shipper's delay, a proposal was made to add language along the following lines to draft article 30, paragraph 1: "The term 'loss' referred to in this article or in article 31 or article 32 does not include the loss caused by delay. Nothing in this Convention prevents the carrier from claiming shipper liability for delay under the applicable law". It was explained that the first sentence of that proposal was intended to clarify that there was no implied cause of action against the shipper for delay under the draft convention, and the second sentence was intended to clarify that any applicable national law relating to the question of shipper's delay remained unaffected. Some support was expressed for that clarifying text.

236. Nevertheless, it was said that the second sentence of the proposed text might be unnecessary as the applicable law would apply automatically to matters beyond the scope of the draft convention. In that regard, it was noted that obligations existed under the draft convention for which there was no corresponding liability on either the carrier's or the shipper's side, and the liability for those obligations was thus left to applicable law.

Conclusions reached by the Working Group regarding draft article 30, paragraph 1

237. After discussions, the Working Group decided that:

- The text of paragraph 1 be reformulated in accordance with its discussions bearing in mind that the liability of the shipper should be fault-based and take account of the contractual relationship between the shipper and the carrier; and
- That references to delay contained in paragraph 1 be deleted with the possible inclusion of text clarifying that the applicable law relating to shipper's delay was not intended to be affected.

Paragraph 2

238. Subject to the deletion of the bracketed text “or delay” in accordance with its earlier decision to delete references to delay, the Working Group was in agreement that paragraph 2 should be approved as drafted.

Revised text of draft article 30

239. In accordance with its earlier decision to consider the reformulated text of draft article 30, paragraph 1 (see above, paras. 220 to 237), the Working Group continued its deliberations on the following revised text of that provision:

“Article 30. Basis of the shipper’s liability to the carrier

“1. The shipper is liable for loss or damage sustained by the carrier if the carrier proves that such loss or damage was caused by a breach of the shipper’s obligations pursuant to articles 27, [and] 29, subparagraphs 1(a) and (b) [and 31, paragraph 1].

“2. Except in respect of loss or damage caused by a breach by the shipper of its obligations under articles 31 [, paragraph 2,] and 32, the shipper is relieved of all or part of its liability if the cause or one of the causes of the loss or damage is not attributable to its fault or to the fault of any person referred to in article 34.”

240. It was explained that the redrafted text was based on the proposal made to the Working Group (see above, para. 230), along with the general views expressed in the Working Group with respect to draft article 30. It was further explained that the text in square brackets in both paragraphs was intended to indicate only that the references therein should be adjusted according to the necessary clarifications to be made to draft article 31, in order to ensure that the obligation to provide accurate information was made subject to strict liability, and that the obligation to provide timely information was based on fault. It was also noted that a correction should be made to the final line of the draft text of paragraph 1, deleting the reference to “(a) and (b)”.

241. Although there was some support for the reinsertion of a reference in paragraph 2 that it was the shipper’s responsibility to prove that the cause of the loss or damage was not attributable to its fault, there was broad agreement in the Working Group for the structure and approach of the revised text as drafted.

242. Two drafting suggestions met with approval in the Working Group, and should be examined by the Secretariat:

(a) Paragraph 1 could be redrafted to refer to all of the shipper’s liabilities, including both the fault-based liability and strict liability, since the carrier had to prove the same loss or damage and breach of the shipper’s obligation in both contexts; and

(b) Paragraph 2 could be restructured to refer first to the general principle, and next to the exception.

Conclusions reached by the Working Group regarding the revised text

243. After discussion, the Working Group decided that:

- It was satisfied that the revised text corresponded to its earlier discussion;

- The drafting suggestions as set out in the paragraph above should be considered by the Secretariat; and
- The revised text was otherwise generally acceptable to the Working Group.

Draft article 31. Information for compilation of contract particulars

244. The Working Group was reminded that its most recent consideration of the content of draft article 31 on information for the compilation of contract particulars was at its seventeenth session (see A/CN.9/594, paras. 187 to 194). The Working Group proceeded to consider draft article 31 as contained in A/CN.9/WG.III/WP.81.

Paragraph 1

245. It was noted that due to a typographical error, draft paragraph 1 made reference only to draft article 37, subparagraphs 1 (a), (b) and (c), and it was agreed that the reference should be corrected to include subparagraph 37 (1)(d). It was further indicated that the draft provision had antecedents in the Hague-Visby and Hamburg Rules, and that it was a particularly important provision since it set out the shipper's obligation that would trigger the strict liability provision in draft article 31 (2). Given the serious consequences of a breach of the obligations set out in draft paragraph 1, it was suggested that the use of the word "including" in the draft paragraph was too broad and that it should be more precise in order to provide the shipper with greater predictability regarding its potential strict liability.

246. The Working Group was in agreement that draft paragraph 1 should be corrected through the addition of a reference to subparagraph 37 (1)(d), but that the provision could be accepted, bearing in mind that an adjustment to the drafting might be necessary in order to render the text more precise, as indicated in the above paragraph.

Paragraph 2

247. It was recalled that the Working Group had agreed to delete from the text of the draft convention all instances of shipper's liability for delay (see above, paras. 182 to 184), and that the reference to "delay" in square brackets in the draft paragraph would be deleted accordingly. A question was raised with respect to the fact that draft paragraph 2 set out the liability of the shipper for the accuracy of the information provided to the carrier, but not with respect to its timeliness. It was explained that, in keeping with the Hague-Visby and the Hamburg Rules, the Working Group had decided at an earlier session to render a failure by the shipper to provide accurate information to be subject to strict liability, while it had intended to make a failure by the shipper to provide timely information subject only to liability based on the fault of the shipper.

248. The Working Group was in agreement that paragraph 2 should be approved as drafted, with the deletion of the reference to "delay."

Draft article 32. Special rules on dangerous goods

249. The Working Group was reminded that its most recent consideration of the content of draft article 32 on special rules for dangerous goods was at its seventeenth session (see A/CN.9/594, paras. 195 to 198). The Working Group proceeded to consider draft article 32 as contained in A/CN.9/WG.III/WP.81, bearing in mind that the references to "delay" in square brackets were to be deleted

in accordance with the previous decision of the Working Group (see above, paras. 182 to 184).

“[or become]”

250. The Working Group first considered the phrase “or become” as it appeared in square brackets in the chapeau of draft article 32. In light of concerns regarding the safety of shipping, it was suggested that the text should be retained in the draft provision and the brackets deleted in order to allow for the widest possible scope for the prevention of accidents involving dangerous goods, such that it would include those that were dangerous prior to and during the voyage. In response, doubts were raised as to whether the inclusion of the phrase “or become” was necessary in light of the inclusion in the chapeau of the phrase “reasonably appear likely to become”, which was said to be sufficiently broad to include all risks. Further, it was said that it would be unfair to hold the shipper liable for a failure to inform the carrier about the nature of the goods if they only became dangerous during the voyage, well after they had been delivered by the shipper for carriage. As such, it was thought that the best solution would be to delete the phrase “or become”.

251. There was broad support in the Working Group for the deletion of the phrase “or become”, however, a suggestion to delete the word “reasonably” as redundant in the phrase “reasonably appear likely to become” was not supported.

“[the carriage of such goods]/[such failure to inform]”

252. It was suggested that the variant “the carriage of such goods” in subparagraph (a) should be retained and the variant “such failure to inform” should be deleted, since the carrier could suffer potentially enormous losses due to the shipper’s failure to provide information on the dangerous nature of the goods, such that retention of the phrase offering the broadest protection was warranted. However, that suggestion was not taken up, and there was strong support in the Working Group for the retention of the phrase “such failure to inform” as better addressing the issue of causation of the damage than the phrase “the carriage of such goods”, which should be deleted. It was further noted that the phrase “such failure to inform” was more consistent with the approach taken to causation in draft subparagraph (b).

Conclusions reached by the Working Group regarding draft article 32

253. After discussion, the Working Group decided that:

- The phrase “or becomes” in the chapeau of draft article 32 should be deleted along with the square brackets surrounding it;
- References to the shipper’s liability for delay should be deleted and the text adjusted accordingly;
- The phrase “such failure to inform” should be retained in the text and the square brackets surrounding it deleted, and the phrase “the carriage of such goods” should be deleted along with the square brackets surrounding it; and
- The text of draft article 32 was otherwise accepted by the Working Group.

Draft article 33. Assumption of the shipper's rights and obligations by the documentary shipper

254. The Working Group was reminded that its most recent consideration of the content of draft article 33 on the assumption of the shipper's rights and obligations by the documentary shipper was at its sixteenth session (see A/CN.9/591, paras. 171 to 175). The Working Group proceeded to consider draft article 33 as contained in A/CN.9/WG.III/WP.81.

255. It was observed that the definition of "documentary shipper" as set out in paragraph 10 of draft article 1 had been created from the first sentence of the previous version of the draft provision as found in A/CN.9/WG.III/WP.56.

256. The Working Group agreed that draft articles 1 (10) and 33 should be approved as drafted.

Draft article 34. Liability of the shipper for other persons

257. The Working Group was reminded that its most recent consideration of the content of draft article 34 on the liability of the shipper for other persons was at its sixteenth session (see A/CN.9/591, paras. 176 to 180). The Working Group proceeded to consider draft article 34 as contained in A/CN.9/WG.III/WP.81.

Paragraph 1

258. It was suggested that the bracketed text in draft paragraph 1 should be retained and the brackets surrounding it deleted, since it was thought that the shipper should not be held responsible for the actions of the carrier. While it was questioned whether the text in square brackets was necessary, it was agreed that, if it provided clarification of the draft provision, its inclusion was acceptable. There was broad support for the retention of the text in square brackets. In addition, the Working Group requested the Secretariat to address the drafting problem raised during the consideration of draft articles 14 (2), 27 (2) and 17 (3)(h) (see above, para. 157), which should be rendered consistent with draft article 34 (1) with regard to whether the shipper was responsible for the acts and omissions of the controlling party and the consignee.

Paragraph 2

259. The Working Group agreed to delete draft paragraph 2, based on its earlier decision to delete draft article 18 (2) (see above, para. 78).

Conclusions reached by the Working Group regarding draft article 34

260. After discussion, the Working Group decided that:

- The phrase in square brackets in draft article 34 (1) should be retained and the square brackets surrounding it should be deleted;
- The Secretariat was requested to make the necessary adjustments to draft articles 14 (2), 27 (2), 17 (3)(h) and 34 in order to render consistent the treatment of the shipper's responsibility for the acts of the consignee and the controlling party; and
- Draft article 34 (2) should be deleted.

Draft article 35. Cessation of shipper's liability

261. The Working Group was reminded that its most recent consideration of the content of draft article 35 regarding the cessation of the shipper's liability was at its sixteenth session (see A/CN.9/591, paras. 181 to 183). The Working Group proceeded to consider draft article 35 as contained in A/CN.9/WG.III/WP.81.

262. It was noted that the reference in subparagraph (a) should be corrected to read "article 33" rather than "article 35", and that given the defined term "documentary shipper" in draft article 1 (10), that term should be used instead of the reference to "a person referred to in article 33". In addition, the Secretariat was requested to consider whether the term "documentary shipper" could also be substituted for the phrase in the chapeau of the draft provision "any other person identified in the contract particulars as the shipper", and whether any adjustment should be made to the title of the draft article in terms of adding the documentary shipper. In addition, it was suggested that the term "void" should be used instead of "not valid" in the chapeau, and that draft subparagraph (c) should be retained in square brackets until the Working Group had made its final decision regarding chapter 12 on transfer of rights.

Conclusions reached by the Working Group regarding draft article 35

263. After discussion, the Working Group decided that:

- The reference to "article 35" should be corrected to "article 33", and the term "documentary shipper" as defined in draft article 1 (10) should be used in subparagraph (a) and possibly in the chapeau;
- Consideration should be given to changing the word "not valid" to "void"; and
- Draft article 35 (c) should be retained in square brackets pending a decision by the Working Group on chapter 12.

Chapter 9. Transport documents and electronic transport records

264. The Working Group was reminded that its most recent consideration of draft chapter 9 on transport documents and electronic transport records had commenced at its seventeenth session (see A/CN.9/594, paras. 216 to 233) and had continued at its eighteenth session (see A/CN.9/616, paras. 9 to 82). It was also recalled that the most recent complete consideration of the topic by the Working Group had taken place during its eleventh session (see A/CN.9/526, paras. 24-61), and that a written proposal regarding the identity of the carrier in then draft article 40 (3) had been submitted for the consideration of the Working Group for its eighteenth session (see A/CN.9/WG.III/WP.79). The consideration by the Working Group of the provisions of chapter 9 at the present session was based on the text as set out in A/CN.9/WG.III/WP.81.

265. The Working Group was reminded that the substantive articles contained in draft chapter 9 were closely related to a number of definitions, including those contained in subparagraphs 16, 17, 18, 20, 21, 22 and 23 of draft article 1.

Draft article 36. Issuance of the transport documents or the electronic record

266. The Working Group noted that draft article 36 had been amended as agreed by the Working Group at its seventeenth session (A/CN.9/594, paras. 223 and 224).

267. Support was expressed for draft article 36 as drafted. It was noted that subparagraph (b) entitled the shipper to obtain from the carrier either a negotiable or non-negotiable transport document but that the latter part of subparagraph (b) did not entitle the shipper to obtain a negotiable transport document if the shipper and carrier had agreed not to use a negotiable transport document or a negotiable electronic transport document. A clarification was sought as to whether a shipper could nevertheless obtain a non-negotiable transport document or non-negotiable electronic transport document in that circumstance. It was agreed that such was the intention of subparagraph (b) and if that was not clear then the text should be clarified. It was suggested that the subparagraph could be restructured so that the exception to the principle which was currently contained in the chapeau could appear after the principle which was stated in subparagraphs (a) and (b).

Conclusions reached by the Working Group regarding draft article 36

268. The Working Group decided that, subject to the proposed drafting suggestions, the text in draft article 36 as found in A/CN.9/WG.III/WP.81 should be approved.

Draft article 37. Contract particulars

269. The Working Group took note that draft article 37 had been redrafted as agreed by the Working Group at its seventeenth session (A/CN.9/594, paras. 225 and 233).

Paragraph 1

270. The Working Group considered paragraph 1 as contained in A/CN.9/WG.III/WP.81 and a proposal in respect of subparagraph (1) (a) of that draft article as contained in A/CN.9/WG.III/WP.86.

271. It was noted that subparagraph 1 (a) obliged the carrier to include a “description of the goods” as furnished by the shipper and that the draft convention contained no limits as to the amount of information that could be provided by the shipper. In light of the increasing tendency of shippers to provide lengthy and detailed technical descriptions of goods for inclusion in the transport document particularly since the use of computers had facilitated such lengthy descriptions, a proposal was made to introduce a limit as to the length, nature and degree of detail of the information the shipper might seek to include in the transport document. It was noted that without such a limitation, a carrier would be obliged to perform a reasonable check of all information furnished by the shipper which was physically practicable and commercially reasonable to check in accordance with draft article 41, subparagraph 2 (a). As well, it was noted that as the description of goods would often be transferred to the cargo manifest, overly lengthy descriptions could overburden customs and security authorities as well as banks. To address that concern it was proposed to amend subparagraph 1 (a) so that it read as follows: “a description in general terms of the goods”. Support was expressed for that proposal given that it was based on the wording of subparagraph 1 (a) of article 15 of the Hamburg Rules.

272. However, a concern was expressed that the reference to “in general terms” might be too vague and an amended proposal was made to include wording along

the following lines: “a description as appropriate for the transport” to cover situations such as where import restrictions applied in respect of certain goods and to provide sufficient information, particularly in relation to dangerous goods. Support was expressed for that proposal and it was suggested that the word “relevant” might be substituted for, or included in addition to, the word “appropriate”.

273. In response, it was said that the proposal was not intended to affect the carrier’s right to reject information that did not meet the requirements needed for any customs clearances or relating to security. It was noted that subparagraph 1 (b) of draft article 29 also required the shipper to provide information as reasonably necessary to, inter alia, allow the carrier to comply with the law. Nevertheless, support was expressed for the amended proposal for the reason that it appeared to reflect both a minimum and maximum limit for information that ought to be included.

Additional particulars

274. Proposals were made that the list contained in draft article 37, paragraph 1, should also refer to the consignee, the date of delivery, where it had been agreed upon, the name of the vessel, the loading and unloading ports and an indication of whether the goods were of a dangerous nature. In response, it was said that the list of contract particulars contained in article 37 had already been decided upon by the Working Group and should not be reconsidered without adequate consensus in that regard. As well, it was noted that requiring inclusion of the name of a vessel, whilst possible in a port-to-port context, would be almost impossible in the door-to-door context when a carrier was often not the ship owner but instead a non-vessel operating carrier. In response, it was said that the intention was not to revisit the issue but rather to align draft article 37 with draft article 31, which related to information for compilation of contract particulars, and which had been revised at the current session.

“the transport document or electronic transport document referred to in article 36”

275. It was noted that paragraphs 1 and 2 of draft article 37 referred to “the transport document or electronic transport document referred to in article 36”. It was suggested that that reference should be confined to a transport document or electronic transport document referred to in draft article 36, paragraph (b) only, given that the documents covered by paragraph (a) of that draft article merely evidenced receipt of the goods. There was support for that proposal.

Paragraph 2

276. It was suggested that the reference to the “name and address of a person identified as a carrier” could be misinterpreted as permitting the naming of a person other than a contractual carrier as the carrier in the transport document and thereby create a so-called “documentary carrier”. It was noted that such had not been the intention of the Working Group. To avoid such difficulties, it was suggested that the text refer simply to the name and address of the carrier, as contained in an earlier version of paragraph 2. It was noted that the text had been changed to follow the language used in UCP 500. However, it was said that the new UCP 600 no longer referred to the “name and address of a person identified as a carrier”. The Secretariat was requested to confirm that the language used in subparagraph 2 (a) was consistent with the approach taken in UCP 600.

Conclusions reached by the Working Group regarding draft article 37

277. The Working Group agreed:

- To amend paragraph 1 (a) to contain language along the following lines: “a description as appropriate for the transport”;
- To review paragraph 2 (a) to ensure its consistency with UCP 600; and
- To approve paragraph 3.

Draft article 38. Identity of the carrier

278. The Working Group took note that draft article 38 had been redrafted as agreed by the Working Group at its eighteenth session (A/CN.9/616, para. 28).

Paragraph 1

279. A proposal was made to refer to “a carrier” rather than “the carrier” given that the words “the carrier” implied identification already.

280. A proposal was made to delete paragraph 1 as it appeared to act as an absolute presumption by providing that if a carrier was identified by name, then any contrary information in the transport document should have no effect. It was said that the naming of a carrier should merely raise a rebuttable presumption. However, support was expressed for the retention of paragraph 1 given that there might be doubts as to the identity of a carrier, particularly where there was inconsistency between the named carrier on the face of a transport document from that on the reverse of that document. Some concern was expressed that the words “by name” might be confusing in some language versions. However it was noted that the words “by name” were necessary to indicate that the actual name of the carrier, and not merely a logo or other circumstantial evidence, was the essential element.

Paragraph 2

281. A proposal was made to delete both variants of paragraph 2 for the reasons that:

- A presumption that the registered owner of the ship was the carrier was unfair given that the owner might have no knowledge of the contract of carriage;
- The registered owner was often a separate entity from the ship owner;
- A document holder that relied on a document that plainly did not state the name of the carrier and failed to take reasonable measures to ascertain the identity of the carrier did not deserve protection; and
- There was substantial jurisprudence on the identity of the carrier in a number of jurisdictions and the relationship of paragraph 2 to that jurisprudence was unclear.

282. That proposal received some support but it was suggested that, if paragraph 2 were retained, it should be limited in scope to situations where the wrong person was named in the contract of carriage. It was further suggested that, if paragraph 2 were ultimately retained, then paragraph 3 should also be kept to avoid the actual carrier from using the presumption that the registered owner of the ship was the carrier as a defence.

283. It was noted that retention of paragraph 2 was not of great import in those jurisdictions that allowed the shipper to seek the arrest of the ship directly against the registered owner to secure claims against the carrier, but it was suggested that retention of the paragraph was preferable. It was also said that a registered owner could not be said to be totally unrelated to the contract of carriage, since the owner of a ship should be expected to take interest in the purposes for which the ship was used.

284. Some support was expressed for the retention of Variant A, but broad support was expressed for the retention of Variant B as it was consistent with modern shipping practice in its recognition that the registered ship owner might not be the person who entered into the contract of carriage. It was said that Variant B represented a compromise approach that allowed a registered owner to identify the proper carrier and covered situations of registered owners as well as bareboat charterers which was more appropriate to modern practices, particularly in the liner container transport context. As well, it was noted that the rule contained in paragraph 2 was consistent with the new rule that performing parties were jointly liable with carriers given that the registered ship owner was a performing party.

285. Proposals were made to amend Variant B as follows:

- Delete “bareboat” from paragraph 2; and
- For the sake of clarity, delete “in the same manner” and substitute the words “in the same manner as the registered owner of the ship”.

286. Some support was expressed for the addition of the clarifying words “in the same manner as the registered owner of the ship”. However, opposition was expressed to deletion of the term “bareboat” given that the bareboat charterer would, in practice, often be treated in the same way as a ship owner, since it related particularly to a charter for a ship, and should therefore have the same possibilities of rebutting any presumption that were available to the registered owner of the ship. In that respect, it was noted that in simply referring to a “charterer”, reference would not necessarily be had to the charterer of a ship, but rather could encompass a voyage charterer or a time charterer, who only contracted for the services of the ship, and could thus not be considered akin to a registered owner for the purposes of identifying the carrier.

Paragraph 3

287. It was suggested that the purpose of paragraph 3 was better expressed in footnote 122 of A/CN.9/WG.III/WP.81 than the text as contained therein. It was agreed to reformulate the paragraph based on that footnote.

Conclusions reached by the Working Group regarding draft article 38

288. The Working Group:

- Accepted paragraph 1 as drafted;
- Accepted Variant B of paragraph 2 and referred the text to the Secretariat to consider whether or not the text should better clarify that the bareboat charterer might defeat the presumption of being the carrier in the same manner that the registered owner might defeat such a presumption; and

- Requested that paragraph 3 be redrafted based on the language used in footnote 122 of A/CN.9/WG.III/WP.81.

Draft article 39. Signature

Paragraph 1

289. The Working Group noted that draft article 39 had been redrafted as agreed by the Working Group when it has last discussed the draft provision at its eighteenth session (A/CN.9/616, para. 12 and 13) by substituting the phrase “by or on behalf of the carrier” for the phrase “by the carrier or a person having authority from the carrier”.

290. It was noted that, as drafted, paragraph 1 might not conform with the rules relating to transport documents contained in the UCP 600, which provided that any signature by an agent indicated that it was signing for or on behalf of the carrier. It was suggested that paragraph 1 be amended so as to conform with the language contained in UCP 600. A further proposal was made that the words “or a person duly mandated by the latter” should replace the words “or a person acting on its behalf” so as to clarify that the person was acting within a mandate granted by the carrier.

291. In reply, it was said that the UCP 600 had a different purpose to the draft convention, in that the former was concerned with facilitating the system of documentary credits, while the latter set out legal rules with legal consequences. It was recalled that, while the insertion of additional text might clarify paragraph 1, the Working Group had already agreed to leave issues of agency to the applicable law, rather than dealing with them in the draft convention. The Working Group agreed to accept paragraph 1 as drafted.

Paragraph 2

292. The Working Group was in agreement that draft paragraph 2 should be approved as drafted.

Conclusions reached by the Working Group regarding draft article 39

293. The Working Group accepted draft article 39 as drafted.

Draft article 40. Deficiencies in the contract particulars

294. The Working Group was reminded that its most recent consideration of draft article 40 on deficiencies in the contract particulars was at its eighteenth session (see A/CN.9/616, paras. 10 to 13). The Working Group proceeded to consider draft article 40 as contained in A/CN.9/WG.III/WP.81.

295. Subject to a few adjustments to the text of the provision in different language versions, the Working Group accepted paragraphs 1, 2 and 3 of draft article 40 as drafted.

Proposed paragraph 4 of draft article 40

296. As indicated in footnote 129 of A/CN.9/WG.III/WP.81, the Working Group had in a previous session agreed to add to draft article 37 (2) a new subparagraph (d) requiring the number of original negotiable transport documents to be included in the contract particulars when more than one original was issued. It was noted that the draft convention did not state the legal effect of a failure to include that

information in the contract particulars. It was proposed that, in order to provide the holder of one of the original negotiable transport documents and the carrier with some certainty, the legal effect of such a failure should be that when there was no indication of the number of originals in the contract particulars, the negotiable transport document would be deemed to have stated that only one original was issued. It was suggested that such a provision should be included in the text as draft paragraph 4 of article 40. There was support in the Working Group for that suggestion.

Conclusions reached by the Working Group regarding draft article 40

297. The Working Group accepted draft article 40 as drafted, and requested the Secretariat to draft a new paragraph 4 in keeping with the approach discussed in the paragraph above.

Draft article 41. Qualifying the description of the goods in the contract particulars

298. The Working Group was reminded that its most recent consideration of the content of draft article 41 on the qualifying the description of the goods in the contract particulars was at its eighteenth session (see A/CN.9/616, paras. 29 to 39 and 69 to 73). The Working Group proceeded to consider draft article 41 as contained in A/CN.9/WG.III/WP.81.

299. Some drafting suggestions were made with respect to draft article 41. A suggestion was made to adjust the title of the draft article so that it referred to “information” rather than to “description”, which seemed to limit it to draft article 37 (1)(a) only. In paragraph 41 (1)(a), it was suggested that the word “materially” before the phrase “false or misleading” could be deleted as redundant. An additional suggestion was made to coordinate the text of paragraphs 1, 2 and 3, which all used the term “qualify”, while paragraph 1 referred to a type of correction, and paragraphs 2 and 3 referred more to reservations. Finally, it was suggested that in draft paragraphs 1 (b) and 2 (b), reference was made to the accuracy of the information, for which the shipper was held strictly liable under the draft convention, and that in light of that fact, it might be preferable to use the phrase “the carrier has reasonable grounds to believe” rather than “the carrier reasonably considers.”

Conclusions reached by the Working Group regarding draft article 41

300. The Working Group accepted draft article 41 as drafted, subject to adjustments made to the text by the Secretariat in light of the suggestions in the paragraph above.

Draft article 42. Evidentiary effect of the contract particulars

301. The Working Group was reminded that its most recent consideration of the content of draft article 42 on the evidentiary effect of the contract particulars was at its eighteenth session (see A/CN.9/616, paras. 45 to 68). The Working Group was reminded that draft article 42 as contained in A/CN.9/WG.III/WP.81 was the product of extensive debate and compromise at its eighteenth session, and a preference was expressed to postpone the third reading of that provision until the twentieth session of the Working Group, in order to accord it sufficient time for thorough discussion of subparagraph (a), which had since been included in the draft article.

Conclusions reached by the Working Group regarding draft article 42

302. The Working Group agreed to postpone the third reading of draft article 42 until its twentieth session.

Draft article 43. “Freight prepaid”

303. The Working Group was reminded that its most recent consideration of draft article 43 on “freight prepaid” was at its eighteenth session (see A/CN.9/616, paras. 74 to 82). The Working Group proceeded to consider draft article 43 as contained in A/CN.9/WG.III/WP.81. A suggestion to insert a good faith requirement was rejected on the grounds that such a requirement was self-evident.

Conclusions reached by the Working Group regarding draft article 43

304. The Working Group accepted draft article 43 as drafted.

III. Other business

Planning of future work

305. The Working Group agreed to continue with its third reading, commencing with draft article 42, and continuing with chapter 10 of the draft convention, at its twentieth session (Vienna, 15 to 25 October, 2007). The Working Group also took note that its twenty-first session was scheduled for 7 to 18 April 2008, but that the scheduling of both sessions was subject to the approval of the Commission at its fortieth session in 2007.

**K. Note by the Secretariat on the preparation of a draft convention on the
carriage of goods [wholly or partly] [by sea], submitted to the Working Group on
Transport Law at its nineteenth session**

(A/CN.9/WG.III/WP.81 and Corr.1) [Original: English]

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Introduction

1. At its thirty-fourth session, in 2001, the Commission established Working Group III (Transport Law) and entrusted it with the task of preparing, in close cooperation with interested international organizations, a legislative instrument on issues relating to the international carriage of goods such as the scope of application, the period of responsibility of the carrier, obligations of the carrier, liability of the carrier, obligations of the shipper and transport documents.¹ The Working Group commenced its deliberations on a draft instrument on the carriage of goods [wholly or partly] [by sea] at its ninth session in 2002. The most recent compilation of historical references regarding the legislative history of the draft instrument can be found in document A/CN.9/WG.III/WP.80.

2. This document consists of a consolidation of revised provisions for the draft convention on the carriage of goods [wholly or partly] [by sea] prepared by the Secretariat for consideration by the Working Group for the third reading of the draft convention. Changes to the consolidated text most recently considered by the Working Group (contained in document A/CN.9/WG.III/WP.56) have been indicated in footnotes to the text indicating those changes and, where applicable, by reference to the working paper in which the revised text appeared, or to the paragraph of the report in which such text appeared.

¹ *Official Records of the General Assembly, Fifty-sixth Session, Supplement No. 17* and corrigendum (A/56/17 and Corr. 3), para. 345.

Draft convention on the carriage of goods [wholly or partly] [by sea]

CHAPTER 1. GENERAL PROVISIONS

Article 1. Definitions

For the purposes of this Convention:

1. “Contract of carriage” means a contract in which a carrier, against the payment of freight, undertakes to carry goods from one place to another. The contract shall provide for carriage by sea and may provide for carriage by other modes of transport in addition to the sea carriage.¹

2. “Volume contract” means a contract of carriage that provides for the carriage of a specified quantity of goods in a series of shipments during an agreed period of time. The specification of the quantity may include a minimum, a maximum or a certain range.²

3. “Liner transportation” means a transportation service that is offered to the public through publication or similar means and includes transportation by ships operating on a regular schedule between specified ports in accordance with publicly available timetables of sailing dates.³

4. “Non-liner transportation” means any transportation that is not liner transportation.⁴

5. “Carrier” means a person that enters into a contract of carriage with a shipper.

6. “Performing party” means a person other than the carrier that performs⁵ or undertakes to perform any of the carrier’s obligations⁶ under a contract of carriage with respect to the receipt, loading, handling, stowage, carriage, care, discharge or delivery of the goods, to the extent that such person acts, either directly or indirectly, at the carrier’s request or under the carrier’s supervision or control. It includes employees, agents and subcontractors of a performing party to the extent that they likewise perform or undertake to perform any of the carrier’s obligations

¹ Text as set out in para. 16 of A/CN.9/WG.III/WP.61, as considered by the Working Group in paras. 121 to 133 of A/CN.9/594.

² Text as set out in para. 16 of A/CN.9/WG.III/WP.61, as considered by the Working Group in paras. 121 to 133 of A/CN.9/594.

³ Text as set out in para. 16 of A/CN.9/WG.III/WP.61, as considered by the Working Group in paras. 121 to 133 of A/CN.9/594.

⁴ The Working Group may wish to consider whether the definition of “non-liner transportation” is necessary in light of the definition of “liner transportation”.

⁵ As a drafting improvement, the word “physically” has been deleted from its previous placement in the text in A/CN.9/WG.III/WP.56 prior to the word “perform(s)” in two places in this sentence, since the translation of this phrase in some languages was unclear, and since the list of functions set out in the provision makes it clear that the performing party must take some concrete action in the performance of the contract of carriage in order to be included in the definition.

⁶ In order to standardize the text, the word “obligations” has been substituted for the word “responsibilities”, where appropriate.

under a contract of carriage,⁷ but does not include any person that is retained by a shipper, by a documentary shipper, by the consignor, by the controlling party or by the consignee, or is an employee, agent or subcontractor of a person (other than the carrier) who is retained by a shipper, by a documentary shipper, by the consignor, by the controlling party or by the consignee.

7. “Maritime performing party” means a performing party to the extent⁸ that it performs or undertakes to perform any of the carrier’s obligations during the period between the arrival of the goods at the port of loading of a ship and their departure from the port of discharge of a ship,⁹ but, in the event of a trans-shipment, does not include a performing party that performs any of the carrier’s obligations inland during the period between the departure of the goods from a port and their arrival at another port of loading.

8. “Non-maritime performing party” means a performing party to the extent that it is not a maritime performing party.¹⁰

9. “Shipper” means a person that enters into a contract of carriage with a carrier.

10. “Documentary shipper” means a person other than the shipper that accepts to be named as “shipper” in the transport document or electronic transport record.¹¹

11. “Consignor” means a person that delivers the goods to the carrier or to a performing party for carriage.

12. “Holder” means:

(a) A person that is in possession of a negotiable transport document; and (i) if the document is an order document, is identified in it as the shipper or the consignee, or is the person to which the document is duly endorsed; or (ii) if the document is a blank endorsed order document or bearer document, is the bearer thereof; or

(b) The person to which a negotiable electronic transport record has been issued or transferred and that has exclusive control of that negotiable electronic transport record in accordance with the procedures in article 9.¹²

⁷ The opening phrase of this sentence has been added to clarify further the definition.

⁸ The addition of the phrase “to the extent” is suggested to further clarify the definition to take into account the possibility that the same person may perform both a maritime part and an inland part of the transport.

⁹ The phrases “[or, in case of trans-shipment, at the first port of loading]” and “[or final port of discharge as the case may be]” have been deleted in order to clarify the text and to make it consistent with the definition of “performing party” in the paragraph above. Refinements with respect to the liability of the maritime performing party have been made to draft art. 19. As set out in an earlier note, it was suggested at para. 31 of A/CN.9/544 that a rail carrier, even if it performed services within a port, should be deemed to be a non-maritime performing party. The Working Group may wish to consider this suggestion.

¹⁰ Revised text to maintain consistency with technique used elsewhere in the draft convention, for example, in the definition of “non-liner transportation”. The Working Group may wish to consider whether this definition is necessary, since the term “non-maritime performing party” is used only in draft art. 20(3).

¹¹ This definition was moved from its former position in the first sentence of former draft article 34 as it appeared in A/CN.9/WG.III/WP.56.

¹² The phrase “in accordance with the procedures in article 9” has been added to allow for the deletion of the second sentence of former draft article 1(u) as it appeared in

13. “Consignee” means a person entitled to delivery¹³ of the goods under a contract of carriage or a transport document or electronic transport record.

14. “Right of control” of the goods means the right under the contract of carriage to give the carrier instructions in respect of the goods in accordance with chapter 11.¹⁴

15. “Controlling party” means the person that pursuant to article 53 is entitled to exercise the right of control.

16. “Transport document” means a document issued under a contract of carriage by the carrier or a performing party that satisfies one or both of the following conditions:

(a) Evidences the carrier’s or a performing party’s receipt of goods under a contract of carriage; or

(b) Evidences or contains a contract of carriage.

17. “Negotiable transport document” means a transport document that indicates, by wording such as “to order” or “negotiable” or other appropriate wording recognized as having the same effect by the law applicable to the document, that the goods have been consigned to the order of the shipper, to the order of the consignee, or to bearer, and is not explicitly stated as being “non-negotiable” or “not negotiable”.

18. “Non-negotiable transport document” means a transport document that is not a negotiable transport document.

19. “Electronic communication” means information generated, sent, received or stored by electronic, optical, digital or similar means with the result that the information communicated is accessible so as to be usable for subsequent reference.¹⁵

A/CN.9/WG.III/WP.56, which defined “exclusive control” in a circular fashion by referring to the procedure of draft article 9. If the Working Group decides to delete draft article 59, the definition may require further drafting adjustment.

¹³ The word “take” that had been placed before “delivery” has been deleted as redundant and potentially misleading.

¹⁴ Definition of “right of control” drawn from the chapeau of draft article 52, formerly draft art. 54 as it appeared in A/CN.9/WG.III/WP.56.

¹⁵ Suggested clarification to ensure that the draft convention does not draw an unnecessary distinction between the means of transmission and the form in which the data are stored. The definition of “electronic communication” draws on the definition of “data message” in art. 2 of the United Nations Model Law on Electronic Commerce, 1996 (“MLEC”), without the illustrative list of techniques. In the MLEC and the United Nations Convention on the Use of Electronic Communications in International Contracts (“Electronic Contracting Convention”), Annex I to *Official Records of the General Assembly, Sixtieth Session, Supplement No. 17*, (A/60/17), not all data messages are capable of having the same value as written paper documents, which is only possible in respect of data messages that are “accessible so as to be usable for subsequent reference”. In the draft instrument, the notion of “electronic communication”, also incorporates the criteria for the functional equivalence between data messages and written documents on art. 6 of MLEC and art. 9, para. 2 of Electronic Contracting Convention. Thus, an “electronic communication” under the instrument must always be capable of replicating the function of written documents.

20. “Electronic transport record” means information in one or more messages issued by electronic communication under a contract of carriage by a carrier or a performing party, including information logically associated with the electronic transport record by attachments or otherwise linked to the electronic transport record contemporaneously with or subsequent to its issue by the carrier or a performing party, so as to become part of the electronic transport record, that satisfies one or both of the following conditions:

- (a) Evidences the carrier’s or a performing party’s receipt of goods under a contract of carriage; or
- (b) Evidences or contains a contract of carriage.

21. “Negotiable electronic transport record” means an electronic transport record:

- (a) That indicates, by statements such as “to order”, or “negotiable”, or other appropriate¹⁶ statements recognized as having the same effect by the law applicable to the record, that the goods have been consigned to the order of the shipper or to the order of the consignee, and is not explicitly stated as being “non-negotiable” or “not negotiable”; and
- (b) The use of which meets the requirements of article 9, paragraph 1.

22. “Non-negotiable electronic transport record” means an electronic transport record that is not a negotiable electronic transport record.

23. The “issuance” and the “transfer” of a negotiable electronic transport record means the issuance and the transfer of exclusive control over the record.¹⁷

24. “Contract particulars” means any information relating to the contract of carriage or to the goods (including terms, notations, signatures and endorsements) that is in a transport document or an electronic transport record.

25. “Goods” means the wares, merchandise, and articles of every kind whatsoever that a carrier undertakes to carry under a contract of carriage and includes the packing and any equipment and container not supplied by or on behalf of the carrier.¹⁸

26. “Ship” means any vessel used to carry goods by sea.

27. “Container” means any type of container, transportable tank or flat, swapbody, or any similar unit load used to consolidate goods, and any equipment ancillary to such unit load.

¹⁶ The Working Group may wish to consider whether the word “appropriate” is necessary in light of the use of the phrase “recognized as having the same effect” and whether similar language in draft para. 1(17) should be aligned accordingly.

¹⁷ Text as set out in para. 207 of A/CN.9/576, and as approved for further discussion in para. 210 of A/CN.9/576, but for the second sentence, which has been deleted as a drafting improvement in favour of the addition of the phrase “in accordance with the procedures in article 9” at the end of draft article 1(12)(ii).

¹⁸ The phrase “or a performing party” has been deleted since it should be clear that the performing party is included by way of the use of the phrase “supplied by or on behalf of the carrier”.

28. “Freight” means the remuneration payable to the carrier for the carriage of goods under a contract of carriage.¹⁹

29. “Domicile” means (a) a place where a company or other legal person or association of natural or legal persons has its (i) statutory seat or place of incorporation or central registered office, as appropriate, (ii) central administration, or (iii) principal place of business, and (b) the habitual residence of a natural person.²⁰

30. “Competent court” means a court in a Contracting State that, according to the rules on the internal allocation of jurisdiction among the courts of that State, may exercise jurisdiction over a matter.²¹

Article 2. Interpretation of this Convention

In the interpretation of this Convention, regard is to be had to its international character and to the need to promote uniformity in its application and the observance of good faith in international trade.

Article 3. Form requirements²²

The notices, confirmation, consent, agreement, declaration and other communications referred to in articles 19, paragraph 3; 23, paragraphs 1 to 3; 37, subparagraphs 1(b), (c) and (d); 41, subparagraph 3(b); 45; 50, paragraph 3; 53, paragraph 1; 61, subparagraph (d); 62, paragraph 1; 66; 69; and 89, paragraphs 1 and 5 shall be in writing. Electronic communications may be used for these purposes, provided the use of such means is with the consent²³ of the person by which it is communicated and of the person to which it is communicated.

¹⁹ Deletion of this definition is proposed given the deletion of the chapter on freight and the inclusion of “freight” in the definition of “contract of carriage” in para. 1(1).

²⁰ Suggested adjustments to text as set out in para. 115 of A/CN.9/576. It is suggested that reference should be made to associations, since these legal entities often own ships, but may not be included in “other legal persons”. “Place of incorporation or registered office” have been added for certainty, since “statutory seat” is not universally recognized. All of these changes conform with the text of art. 60 of Council Regulation (EC) No. 44/2001, 22 Dec. 2000 on jurisdiction and the recognition and enforcement of judgements in civil and commercial matters [Official Journal L 12 of 16.01.2001] (“Brussels I”), from which the original text was drawn. Further, the Working Group may wish to note that the definitions of “time of receipt” and “place of receipt” and “time of delivery” and “place of delivery” that formerly appeared in square brackets as draft articles 1(aa) and (bb) in A/CN.9/WG.III/WP.56 have been deleted as redundant, since these terms are already specified in the text as necessary at draft articles 5, 11 and 69.

²¹ As agreed by the Working Group in para. 73 of A/CN.9/591. The phrasing is the same as that used in article 5(3)(b) of the Convention on Choice of Court Agreements, 2005.

²² The Working Group may wish to note that this list is not closed, pending further examination. Further, the Working Group may wish to consider whether it is advisable to include with the final text an explanatory note that any notices contemplated in this convention that are not included in art. 3 may be made by any means including orally or by exchange of data messages that do not meet the definition of “electronic communication”. It is implicit in the definition of “electronic communication” that it must be capable of replicating the function of written documents (see *supra*, note to definition of “electronic communication”).

²³ The phrase “express or implied” that had formerly been inserted before the word “consent” in the text as it appeared in A/CN.9/WG.III/WP.56 has been deleted as redundant.

Article 4. Applicability of defences and limits of liability

The defences and limits of liability provided for in this Convention and the obligations imposed by this Convention apply in any action against the carrier or a maritime performing party for loss of, damage to, or delay in delivery of goods covered by a contract of carriage or for the breach of any other obligation under this Convention,²⁴ whether the action is founded in contract, in tort, or otherwise.²⁵

CHAPTER 2. SCOPE OF APPLICATION

*Article 5. General scope of application*²⁶

1. Subject to article 6, this Convention applies to contracts of carriage in which the place of receipt and the place of delivery are in different States, and the port of loading of a sea carriage²⁷ and the port of discharge of the same sea carriage are in different States, if, according to the contract of carriage, any one of the following places is located in a Contracting State:²⁸

- (a) The place of receipt;
- (b) The port of loading;
- (c) The place of delivery; or
- (d) The port of discharge.

2. This Convention applies without regard to the nationality of the vessel, the carrier, the performing parties, the shipper, the consignee, or any other interested parties.

Article 6. Specific exclusions

1. This Convention does not apply to the following contracts of carriage in liner transportation:

- (a) Charterparties; and
- (b) Contracts for the use of a ship or of any space thereon, whether or not they are charterparties.²⁹

²⁴ The addition of “the breach of any other obligation” is thought to have made the reference to “[or in connection with]” the goods unnecessary.

²⁵ Draft article 4(2) as it existed in A/CN.9/WG.III/WP.56 has been deleted as redundant given the text of draft article 19(4).

²⁶ Revised draft based on A/CN.9/WG.III/WP.61, para. 19, as agreed by the Working Group (A/CN.9/594, paras. 123 and 128).

²⁷ Revised draft based on A/CN.9/WG.III/WP.61, para. 19, as agreed by the Working Group (A/CN.9/594, paras. 123 and 128). The phrases “of a sea carriage” and “of the same sea carriage” have been reinserted into the text in order to emphasize the sea carriage aspect and for enhanced clarity.

²⁸ The phrase “according to the contract of carriage, any one of the following places is located in a Contracting State” has been added to the end of the chapeau in order to allow for deletion of that phrase from the sub-paragraphs that follow. Further, the sub-paragraphs as they appeared in A/CN.9/WG.III/WP.56 have been divided into separate paragraphs so as to make clear that each component listed must be agreed in the contract of carriage.

²⁹ New draft based on A/CN.9/WG.III/WP.61, para. 23, as agreed by the Working Group (A/CN.9/594, paras. 129-133).

2. This Convention does not apply to contracts of carriage in non-liner transportation except when:

(a) There is no charterparty or contract for the use of a ship or of any space thereon between the parties, whether such contract is a charterparty or not; and

(b) The evidence of the contract of carriage is a transport document or an electronic transport record that also evidences the carrier's or a performing party's receipt of the goods.³⁰

*Article 7. Application to certain parties*³¹

Notwithstanding article 6, this Convention applies as between the carrier and the consignor, consignee, controlling party or holder³² that is not an original party to the charterparty or other contract of carriage excluded from the application of this Convention. However, this Convention does not apply as between the original parties to a contract of carriage excluded pursuant to article 6.³³

CHAPTER 3. ELECTRONIC TRANSPORT RECORDS

Article 8. Use and effect of electronic transport records

Subject to the requirements set out in this Convention:

(a) Anything that is to be in or on a transport document pursuant to this Convention may be recorded in an electronic transport record, provided the issuance and subsequent use of an electronic transport record is with the consent³⁴ of the carrier and the shipper; and

(b) The issuance, control, or transfer of an electronic transport record has the same effect as the issuance, possession, or transfer of a transport document.

Article 9. Procedures for use of negotiable electronic transport records

1. The use of a negotiable electronic transport record shall be subject to procedures that provide for:

(a) The method for the issuance and the transfer of that record to an intended holder;

(b) An assurance that the negotiable electronic transport record retains its integrity;

³⁰ Redrafting of text in A/CN.9/WG.III/WP.61, para. 23 (agreed by the Working Group A/CN.9/594, paras. 129-133), not intended to change meaning of paragraph.

³¹ Text based on A/CN.9/WG.III/WP.61, para. 23, as agreed by the Working Group (A/CN.9/594, paras. 134-140).

³² The phrase "or the person referred to in article 34 (now article 33)", as considered by the Working Group in paras. 138 and 140 of A/CN.9/594, has been deleted from the text in A/CN.9/WG.III/WP.61, para. 23 as a clarification, since the application of draft article 7 to the documentary shipper in draft article 33 would be to that person in its capacity as controlling party or holder, but not in its capacity as the documentary shipper.

³³ Text from A/CN.9/WG.III/WP.61, para. 23, as agreed by the Working Group (A/CN.9/594, paras. 134-140), with slight adjustments intended to improve the drafting but to leave unchanged the substance of the draft article.

³⁴ The phrase "express or implied" that had formerly been inserted before the word "consent" in A/CN.9/WG.III/WP.56 has been deleted as redundant.

(c) The manner in which the holder is able to demonstrate that it is the holder; and

(d) The manner of providing confirmation that delivery to the holder has been effected, or that, pursuant to articles 10, paragraph 2, or 49, subparagraphs (a)(ii) and (c), the negotiable electronic transport record has ceased to have any effect or validity.

2. The procedures in paragraph 1 of this article shall be referred to in the contract particulars and be readily ascertainable.³⁵

Article 10. Replacement of negotiable transport document or negotiable electronic transport record

1. If a negotiable transport document has been issued and the carrier and the holder agree to replace that document by a negotiable electronic transport record:

(a) The holder shall surrender the negotiable transport document, or all of them if more than one has been issued, to the carrier;

(b) The carrier shall issue to the holder a negotiable electronic transport record that includes a statement that it replaces the negotiable transport document; and

(c) The negotiable transport document ceases thereafter to have any effect or validity.

2. If a negotiable electronic transport record has been issued and the carrier and the holder agree to replace that electronic transport record by a negotiable transport document:

(a) The carrier shall issue to the holder, in place of the electronic transport record, a negotiable transport document that includes a statement that it replaces the negotiable electronic transport record; and

(b) The electronic transport record ceases thereafter to have any effect or validity.

CHAPTER 4. PERIOD OF RESPONSIBILITY

Article 11. Period of responsibility of the carrier

1. Subject to article 12, the period of responsibility of the carrier for the goods under this Convention begins when the carrier or a performing party receives the goods for carriage and ends when the goods are delivered.³⁶

³⁵ As set out in footnote 34 in A/CN.9/WG.III/WP.47, and as agreed in paras. 198-199 of A/CN.9/576, the term “readily ascertainable” was used to indicate without excessive detail that the necessary procedures must be available to those parties who have a legitimate interest in knowing them prior to entering a legal commitment based upon the validity of the negotiable electronic transport record. It was further noted that the system envisaged would function in a manner not dissimilar to the current availability of terms and conditions of bills of lading. The Working Group may wish to consider whether related detail should be specified in a note or a commentary accompanying the draft convention.

³⁶ The phrase “to the consignee” has been deleted from this paragraph and from subpara. 3(b) as unnecessary, since ‘delivery’ as it is referred to in these provisions concerns not the obligation of the carrier, but rather the actual delivery that defines the end of the period of responsibility of

2. The time and location of receipt of the goods for carriage and of delivery of the goods are the time and location agreed in the contract of carriage, or, failing such agreement, the time and location that are in accordance with the customs, practices, or usages of the trade. In the absence of such agreement or of such customs, practices, or usages:

(a) The time and location of receipt of the goods for carriage are when and where the carrier or a performing party actually takes custody of the goods; and

(b) The time and location of delivery are that of the discharge or unloading of the goods from the final means of transport in which they are carried under the contract of carriage.³⁷

3. If the consignor is required to hand over the goods at the place of receipt, or if the carrier is required to hand over the goods at the place of delivery, to an authority or other third party to which, pursuant to the law or regulations of the place of receipt or delivery, the goods must be handed over and from which the carrier, or the consignee, as the case may be, may collect them:³⁸

(a) The time and location of the carrier's collection of the goods from the authority or other third party are the time and location of the receipt of the goods by the carrier pursuant to subparagraph 2(a) of this article; and

(b) The time and location of such handing over at the place of delivery are the time and location of delivery of the goods by the carrier pursuant to subparagraph 2(b) of this article.

4. For the purposes of determining the carrier's period of responsibility and subject to article 14, paragraph 2, the contract of carriage may not provide that:

(a) The time of receipt of the goods is subsequent to the commencement of their initial loading under the contract of carriage; or

(b) The time of delivery of the goods is prior to the completion of their final discharge under the contract of carriage.³⁹

*Article 12. Transport not covered by the contract of carriage*⁴⁰

On the request of the shipper, the carrier may agree to issue a single transport document or electronic transport record that includes specified transport that is not covered by the contract of carriage. In such event, [the responsibility of the carrier covers the period of the contract of carriage and, unless otherwise agreed, the carrier, on behalf of the shipper, shall arrange the additional transport as provided in

the carrier.

³⁷ Para. 2 combines and replaces former paragraphs 2 and 4 of this draft article as previously set out in A/CN.9/WG.III/WP.56. The change is intended as a drafting improvement and not as a change in substance.

³⁸ This paragraph is proposed by the Secretariat to address the situation when the consignor is required to hand over the goods to an authority, such as a customs authority, prior to them being handed over to the carrier. Further, para. 3 combines and replaces former paragraphs 3 and 5 of this draft article as previously set out in A/CN.9/WG.III/WP.56. The change is intended as a drafting improvement and not as a change in substance.

³⁹ Para. 4 is suggested in order to ensure that fictions may not be included in the contract of carriage in order to reduce the carrier's period of responsibility.

⁴⁰ The Working Group may wish to consider whether art. 12 is properly placed within chapter 4 on period of responsibility.

such transport document or electronic transport record.] [the carrier shall exercise due diligence in selecting the other carrier, conclude a contract with such other carrier on usual and normal terms, and do everything that is reasonably required to enable such other carrier to perform duly under its contract.]⁴¹

CHAPTER 5. OBLIGATIONS OF THE CARRIER

Article 13. Carriage and delivery of the goods

The carrier shall, subject to this Convention and in accordance with the terms of the contract of carriage,⁴² carry the goods to the place of destination and deliver them to the consignee.

Article 14. Specific obligations

1. The carrier shall during the period of its responsibility as defined in article 11, and subject to article 26, properly and carefully receive,⁴³ load, handle, stow, carry, keep, care for, discharge and deliver the goods.

2. Notwithstanding paragraph 1 of this article, and without prejudice to the other provisions in chapter 5 and to chapters 6 to 8,⁴⁴ the parties may agree that the loading, handling, stowing or discharging of the goods is to be performed by the shipper, any person referred to in article 34, paragraph 1, the controlling party or the consignee. Such an agreement shall be referred to in the contract particulars.

Article 15. Goods that may become a danger⁴⁵

Notwithstanding articles 13, 14, and 16, paragraph 1, the carrier or a performing party may decline to receive or to load, and may take such other measures as are reasonable, including unloading, destroying, or rendering goods harmless if the goods are, or appear likely to become during the carrier's period of responsibility an actual danger to persons, to property or to the environment.⁴⁶

Article 16. Specific obligations applicable to the voyage by sea

1. The carrier is bound before, at the beginning of, and during the voyage by sea to exercise due diligence to:

⁴¹ Since the first sentence of Variant B of this draft article as it appeared in A/CN.9/WG.III/WP.56 was intended only as a clarification of para. 1 of Variant A, the two variants have been combined into one, where the text in square brackets in the second sentence presents two alternative approaches: the first changes the obligation of the carrier in its arrangement of additional transport from one of due diligence to whatever is agreed in the contract of carriage or elsewhere, and the second alternative maintains an obligation of due diligence on the part of the carrier.

⁴² Suggested deletion of "[properly and carefully]" as unnecessary and repetitious, since "subject to this Convention" already includes proper and careful carriage. Further, draft art. 13 is intended as a general obligation that is enhanced in subsequent articles.

⁴³ "Receive" and "deliver" have been added to ensure they are recognized as carrier's obligations.

⁴⁴ The opening phrase "Notwithstanding paragraph 1 of this article, and without prejudice to the other provisions in chapter 5 and to chapters 6 to 8" has been added to achieve greater clarity.

⁴⁵ The revised text of this draft article combines what appeared as Variant A and Variant B in A/CN.9/WG.III/WP.56.

⁴⁶ The concept of "an illegal or unacceptable danger" to the environment that appeared in the text in A/CN.9/WG.III/WP.56 has been changed to a "danger to the environment" in an effort to make the standard more objective.

- (a) Make and keep the ship seaworthy;
- (b) Properly crew,⁴⁷ equip and supply the ship and keep the ship so crewed,⁴⁸ equipped and supplied throughout the voyage; and
- (c) Make and keep the holds and all other parts of the ship in which the goods are carried, including any containers supplied by the carrier in or upon which the goods are carried, fit and safe for their reception, carriage and preservation.

[2. Notwithstanding articles 13, 14, and 16, paragraph 1, the carrier or a performing party may sacrifice goods when the sacrifice is reasonably made for the common safety or for the purpose of preserving from peril human life or other property involved in the common adventure.]⁴⁹

CHAPTER 6. LIABILITY OF THE CARRIER FOR LOSS, DAMAGE OR DELAY

*Article 17. Basis of liability*⁵⁰

1. The carrier is liable for loss of or damage to the goods, as well as for delay in delivery, if the claimant proves that the loss, damage, or delay, or the event or circumstance⁵¹ that caused or contributed to it took place during the period of the carrier's responsibility as defined in chapter 4.

2. The carrier is relieved of all or part of its liability pursuant to paragraph 1 of this article if it proves that the cause or one of the causes of the loss, damage, or delay is not attributable to its fault or to the fault of any person referred to in article 18, paragraph 1.

3. The carrier is also relieved of all or part of its liability pursuant to paragraph 1 of this article if, alternatively to proving the absence of fault as provided in paragraph 2 of this article, it proves that one or more of the following events or circumstances caused or contributed to the loss, damage, or delay:

- (a) Act of God;
- (b) Perils, dangers, and accidents of the sea or other navigable waters;
- (c) War, hostilities, armed conflict, piracy, terrorism, riots, and civil commotions;
- (d) Quarantine restrictions; interference by or impediments created by governments, public authorities, rulers, or people including detention, arrest, or

⁴⁷ As set out in footnote 56 of A/CN.9/WG.III/WP.36, the gender-neutral word "crew" had been inserted in place of the word "man".

⁴⁸ Ibid.

⁴⁹ As noted at para. 157 of A/CN.9/544, the Working Group decided to maintain draft para. 16(2) in square brackets in its current location, with a view to considering at a later stage whether it should be moved to chapter 17 on general average.

⁵⁰ Redraft of text set out in paras. 31 and 75 of A/CN.9/572, as broadly accepted in paras. 33 and 80 of A/CN.9/572, and as published in A/CN.9/WG.III/WP.56. The redraft of this draft article, which is drawn entirely from the previous text as accepted, is only intended to improve the drafting by simplifying the structure of the draft article, and is not intended to change the content of the provision in any way.

⁵¹ The word "occurrence" has been replaced with "event or circumstance" to standardize the text used elsewhere in the draft article and for greater clarity. Reference to "event or circumstance" has been standardized throughout the draft article.

seizure not attributable to the carrier or any person referred to in article 18, paragraph 1,⁵²

- (e) Strikes, lockouts, stoppages, or restraints of labour;
 - (f) Fire on the ship;
 - (g) Latent defects in the [ship] [means of transport]⁵³ not discoverable by due diligence;
 - (h) Act or omission of the shipper[, the consignor]⁵⁴ or any person referred to in article 34,⁵⁵ paragraph 1, the controlling party, or the consignee;
 - (i) Loading, handling, stowing, or discharging⁵⁶ of the goods performed pursuant to an agreement in accordance with article 14, paragraph 2, unless the carrier [or a performing party] performs such activity on behalf of the shipper.
 - (j) Wastage in bulk or weight or any other loss or damage arising from inherent defect, quality, or vice of the goods;
 - (k) Insufficiency or defective condition of packing or marking not performed by [or on behalf of] the carrier;
 - (l) Saving or attempting to save life at sea;
 - (m) Reasonable measures to save or attempt to save property at sea;
 - (n) Reasonable measures to avoid or attempt to avoid damage to the environment;
 - (o) Acts of the carrier⁵⁷ in pursuance of the powers conferred by articles 15 and 16, paragraph 2.⁵⁸
4. Notwithstanding paragraph 3 of this article, the carrier is liable for all or part of the loss, damage, or delay if the claimant proves:
- (a) That the fault of the carrier or of a person referred to in article 18, paragraph 1, caused or contributed to the event or circumstance on which the carrier relies; or
 - (b) That an event or circumstance not listed in paragraph 3 of this article contributed to the loss, damage, or delay, and the carrier cannot prove that this event

⁵² Further examination is needed whether the reference to art. 18, paragraph 1, is necessary.

⁵³ The Working Group may wish to consider which of the terms in square brackets is intended to be addressed in this paragraph.

⁵⁴ The Working Group may wish to decide whether draft article 34 is intended to include the “consignor” or not, and should expressly include it in draft article 34, if that is the intention. If draft article 34 includes “consignor”, this reference is not needed.

⁵⁵ Further examination is needed whether the reference to art. 34 is necessary.

⁵⁶ “Discharging” is suggested in order to be consistent with the language in draft art. 14.

⁵⁷ The phrase “or a performing party” that appeared after the word “carrier” in the text in A/CN.9/WG.III/WP.56 has been deleted as redundant, since the performing party has no powers under draft articles 15 and 16.

⁵⁸ The square brackets around this draft paragraph have been removed and the phrase “when the goods have become a danger to persons, property, or the environment or have been sacrificed” have been deleted as unnecessary in light of the Working Group’s consideration of draft arts. 15 and 32 (see A/CN.9/510, paras. 128-130, A/CN.9/591, paras. 157-170, and A/CN.9/594, paras. 195-198).

or circumstance is not attributable to its fault or to the fault of any person referred to in article 18, paragraph 1.

5. The carrier is also liable, notwithstanding paragraph 3 of this article, for all or part of the loss, damage, or delay if:

(a) The claimant proves that the loss, damage, or delay was or was probably caused by or contributed to by (i) the unseaworthiness of the ship; (ii) the improper crewing, equipping, and supplying of the ship; or (iii) the fact that the holds or other parts of the ship in which the goods are carried (including any containers supplied by the carrier in or upon which the goods are carried) were not fit and safe for reception, carriage, and preservation of the goods; and

(b) The carrier can prove neither that the loss, damage, or delay was not caused by any of the events or circumstances referred to in subparagraph 5(a) of this article nor that it complied with its obligation to exercise due diligence pursuant to article 16, paragraph 1.

6. When the carrier is relieved of part of its liability pursuant to this article, the carrier is liable only for that part of the loss, damage or delay that is attributable to the event or circumstance for which it is liable pursuant to this article.

*Article 18. Liability of the carrier for other persons*⁵⁹

1. The carrier is liable for the breach of its obligations pursuant to this Convention caused by the acts or omissions of:

(a) Any performing party; and

(b) Any other person,⁶⁰ that performs or undertakes to perform any of the carrier's obligations under the contract of carriage, to the extent that the person acts, either directly or indirectly, at the carrier's request or under the carrier's supervision or control.⁶¹

[2. The carrier is liable pursuant to paragraph 1 of this article only when the performing party's or other person's act or omission is within the scope of its contract, employment, or agency.]⁶²

⁵⁹ Note that former draft art. 18 as it appeared immediately prior to this provision in A/CN.9/WG.III/WP.56 was deleted following the Working Group's deliberations on draft article 28 (A/CN.9/594, para. 186). The opening phrase of para. 1 as set out in A/CN.9/WG.III/WP.56, "Subject to article 20, paragraph 4", has been deleted as a drafting improvement to avoid an unnecessary cross-reference.

⁶⁰ The phrase "including a performing party's employees, agents and subcontractors" that appeared after the word "carrier" in the text in A/CN.9/WG.III/WP.56 has been deleted as redundant, since that phrase is now included in the definition of "performing party" in draft article 1(6).

⁶¹ The phrase "as if such act or omissions were its own" that appeared in the text in A/CN.9/WG.III/WP.56 has been deleted as redundant.

⁶² The Working Group may wish to consider deleting this paragraph as it may cause evidentiary problems in some jurisdictions where, for example, employees who have started fires with cigarettes or who have stolen cargo have been found to be acting outside of their scope of employment or contract. Deletion of the paragraph would leave the issue of what is within the scope of employment to national law. Similar treatment should be given to para. 2 of draft art. 34.

Article 19. Liability of maritime performing parties

1. A maritime performing party [that initially received the goods for carriage in a Contracting State, or finally delivered them in a Contracting State, or performed its activities with respect to the goods in a port in a Contracting State].⁶³

(a) Is subject to the obligations and liabilities imposed on the carrier under this Convention and is entitled to the carrier's rights and immunities provided by this Convention if the occurrence that caused the loss, damage or delay took place during the period between the arrival of the goods at the port of loading of a ship and their departure from the port of discharge from a ship, when it has custody of the goods or at any other time to the extent that it is participating in the performance of any of the activities contemplated by the contract of carriage, and

(b) Is liable for the breach of its obligations pursuant to this Convention caused by the acts and omissions of any person to which it has entrusted the performance of any of the carrier's obligations under the contract of carriage.⁶⁴

2. [A maritime performing party is liable pursuant to paragraph 1 of this article only when the act or omission of the person concerned is within the scope of its contract, employment, or agency.]⁶⁵

3. If the carrier agrees to assume obligations other than those imposed on the carrier under this Convention, or agrees that its liability is higher than the limits imposed pursuant to articles 63, 62⁶⁶ and 25, paragraph 5, a maritime performing party is not bound by this agreement unless the maritime performing party expressly agrees to accept such obligations or such limits.

4. If an action⁶⁷ is [brought against a maritime performing party]⁶⁸ [brought against an employee or agent of the carrier or a maritime performing party]⁶⁹

⁶³ The phrase "that initially received the goods for carriage in a Contracting State, or finally delivered them in a Contracting State" has been inserted as preferred drafting to the insertion of para. 5 as set out in A/CN.9/WG.III/WP.61, para. 44, as agreed by the Working Group (A/CN.9/594, paras. 140-145). The text of para. 5, as it appeared in A/CN.9/WG.III/WP.61, read as follows: "5. This article does not apply unless the place where the goods are initially received by the maritime performing party or the place where the goods are finally delivered by the maritime performing party is situated in a Contracting State." In addition, the phrase "or performed all of its activities with respect to the goods in a single port in a Contracting State" has been inserted as a drafting improvement to further refine the provision.

⁶⁴ As a drafting improvement and to be consistent with draft article 19, former draft article 20(1)(a) and (b) as they appeared in A/CN.9/WG.III/WP.56 have been combined into one paragraph, and former draft article 20(3) as it appeared in A/CN.9/WG.III/WP.56 has been moved to become subparagraph (b) of draft article 19(1).

⁶⁵ As a drafting improvement and to be consistent with draft article 18, the last sentence of former draft article 20(3) as it appeared in A/CN.9/WG.III/WP.56 has been moved to draft article 19(2). Square brackets have been inserted around this phrase to mirror the treatment of similar phrases elsewhere in the text. See also footnote 62 above to draft art. 18(2), and footnote 110 below to draft article 34(2).

⁶⁶ As set out in footnote 69 of A/CN.9/WG.III/WP.36, the Working Group took note of the suggestion to limit the reference to draft art. 62, since it was stated that, while the reference to paras. (1), (3) and (4) of draft art. 62 was acceptable, para. (2) of draft art. 62 should not be referred to since the performing party was not liable in case of non-localized damage. The Working Group decided that this suggestion might need to be further discussed after a decision had been made regarding the inclusion of para. (2) of draft art. 62 in the draft convention.

⁶⁷ The phrase "under this Convention" has been deleted from the text as it appeared in

[brought against any person referred to in article 18, paragraph 1, or subparagraph 1(a) of this article, other than the carrier,]⁷⁰ that person is entitled to the defences and limits of liability available to the carrier under this Convention if [it proves that]⁷¹ it acted within the scope of its contract, employment, or agency.

Article 20. Joint and several liability and set-off

1. If the carrier and one or more maritime performing parties are liable for the loss of, damage to, or delay in delivery of the goods, their liability is joint and several [, such that each such party is liable for compensating the entire amount of such loss, damage or delay, without prejudice to any right of recourse it may have against other liable parties,]⁷² but only up to the limits provided for in articles 25, 62 and 63.

2. Without prejudice to article 64, the aggregate liability of all such persons shall not exceed the overall limits of liability under this Convention.

[3. If a claimant obtains compensation from a non-maritime performing party for the loss of, damage to, or delay in delivery of the goods, the amount received by the claimant shall be set off against any subsequent claim for that loss, damage or delay that the claimant makes against the carrier or a maritime performing party.]⁷³

A/CN.9/WG.III/WP.56 in order to broaden the application of this provision, which is then limited by the use of the phrase “under this Convention” at the end of the subparagraph.

⁶⁸ This approach was formerly reflected in Variant A of former draft article 20(4) as it appeared in A/CN.9/WG.III/WP.56.

⁶⁹ This approach reflects that taken in former draft article 4(2) as it appeared in A/CN.9/WG.III/WP.56.

⁷⁰ This approach reflects that taken in Variant B of former draft article 20(4) as it appeared in A/CN.9/WG.III/WP.56. Further, the phrase “including employees or agents of the contracting carrier or of a maritime performing party” as it appeared in this provision in A/CN.9/WG.III/WP.56 has been deleted to correspond with the inclusion of that concept in the definition of “maritime performing party” in draft article 1.

⁷¹ The Working Group may wish to consider whether the bracketed text should be deleted in order to reduce the burden of proof on the person entitled to claim the benefit of the defence of limit of liability of the carrier.

⁷² As decided at paras. 12 and 17 of A/CN.9/552, the phrase in square brackets was added for clarification of the meaning of “joint and several liability”. However, the Working Group may wish to consider the use of the term “joint and several liability” in numerous international instruments, including: para. 10(4) of the Hamburg Rules; para. 27(4) of the Uniform Rules concerning the Contract for International Carriage of Goods by Rail, as amended by the Protocol of Modification of 1999 (“CIM-COTIF 1999”); para. 4(5) of the Budapest Convention on the Contract for the Carriage of Goods by Inland Waterway, 2000 (“CMNI”); para. 30(3) of the Convention for the Unification of Certain Rules Relating to International Carriage by Air, as amended by protocols in 1955 and 1975 (“Warsaw Convention”); and para. 36(3) of the Convention for the Unification of Certain Rules for the International Carriage by Air, Montreal 1999 (“Montreal Convention”).

⁷³ As decided at paras. 14 and 17 of A/CN.9/552, a revised draft has been prepared, pending further discussion regarding the preparation of a uniform rule on set-off, or of leaving the issue to domestic law. The Working Group may wish to consider whether this paragraph is necessary or whether it can be deleted. Further, should the Working Group decide to delete the definition of “non-maritime performing party”, the phrase “a performing party other than a maritime performing party” could be substituted for the phrase “a non-maritime performing party”.

Article 21. Delay

Delay in delivery occurs when the goods are not delivered at the place of destination provided for in the contract of carriage within the time expressly agreed upon or, in the absence of such agreement, within the time it would be reasonable to expect of a diligent carrier, having regard to the terms of the contract, the customs, practices and usages of the trade,⁷⁴ and the circumstances of the journey.

Article 22. Calculation of compensation

1. Subject to article 62, the compensation payable by the carrier for loss of or damage to the goods is calculated by reference to the value of such goods at the place and time of delivery established in accordance with article 11.

2. The value of the goods is fixed according to the commodity exchange price or, if there is no such price, according to their market price or, if there is no commodity exchange price or market price, by reference to the normal value of the goods of the same kind and quality at the place of delivery.

3. In case of loss of or damage to the goods, the carrier is not liable for payment of any compensation beyond what is provided for in paragraphs 1 and 2 of this article except when the carrier and the shipper have agreed to calculate compensation in a different manner within the limits of chapter 19.

Article 23. Notice of loss, damage, or delay

1. The carrier is presumed, in absence of proof to the contrary, to have delivered the goods according to their description in the contract particulars unless notice of loss of or damage to⁷⁵ the goods, indicating the general nature of such loss or damage, was given⁷⁶ to the carrier or the performing party that delivered the goods before or at the time of the delivery, or, if the loss or damage is not apparent, within [three working days][seven days][seven working days at the place of delivery][seven consecutive days] after the delivery of the goods. Such a notice is not required in respect of loss or damage that is ascertained in a joint inspection of the goods by the person to whom they have been delivered⁷⁷ and the carrier or the maritime performing party against which liability is being asserted.⁷⁸

2. No compensation is payable pursuant to articles 21 and 63 unless notice of loss due to delay was given to the carrier within 21 consecutive days following delivery of the goods.

3. When the notice referred to in this article is given to the performing party that delivered the goods, it has the same effect as if that notice was given to

⁷⁴ In order to be consistent with other provisions of the draft convention, such as draft article 11, the phrase “customs, practices and usages of the trade” has been inserted instead of the phrase “characteristics of the transport” found in this provision in A/CN.9/WG.III/WP.56.

⁷⁵ “In connection with” deleted as unnecessary in this paragraph.

⁷⁶ The phrase “[by or on behalf of the consignee]” has been deleted to improve drafting since it is irrelevant from whom the notice comes as long as notice is given.

⁷⁷ The term “consignee” has been replaced with “person to whom they have been delivered” in order to clarify that what is meant in this provision is joint inspection by the person who receives the goods who may not actually be the consignee in a legal sense.

⁷⁸ Variant A of para. 1 as set out in A/CN.9/WG.III/WP.56 has been chosen for insertion over Variant B as representing better drafting with greater clarity and entailing no substantive difference in meaning.

the carrier, and notice given to the carrier has the same effect as a notice given to a maritime performing party.

4. In the case of any actual or apprehended loss or damage, the parties to the dispute shall give all reasonable facilities to each other for inspecting and tallying the goods and shall provide access to records and documents relevant to the carriage of the goods.

CHAPTER 7. ADDITIONAL PROVISIONS RELATING TO PARTICULAR STAGES OF CARRIAGE

Article 24. Deviation during sea carriage

When pursuant to national law, a deviation constitutes a breach of the carrier's obligations, such deviation of itself shall not deprive the carrier or a maritime performing party of any defence or limitation of this Convention, except to the extent provided in article 64.⁷⁹

*Article 25. Deck cargo on ships*⁸⁰

1. Goods may be carried on the deck of a ship only if:

- (a) Such carriage is required by law; or
- (b) They are carried in or on containers⁸¹ on decks that are specially fitted to carry such containers; or
- (c) The carriage on deck is in accordance with the contract of carriage, or⁸² the customs, usages, and practices of the trade in question.

2. The provisions of this Convention relating to the liability of the carrier apply to the loss of, damage to or delay in the delivery of goods carried on deck pursuant to paragraph 1 of this article, but the carrier is not liable for loss of or damage to such goods, or delay in their delivery, caused by the special risks involved in their carriage on deck when the goods are carried in accordance with subparagraphs 1(a) or (c) of this article.⁸³

3. If the goods have been carried on deck in cases other than those permitted pursuant to paragraph 1 of this article, the carrier is liable for loss of or damage to the goods or delay in their delivery that is exclusively caused by their carriage on deck, and is not entitled to the defences provided for in article 17.

⁷⁹ Variants A and B as they appeared in A/CN.9/WG.III/WP.56 have been deleted as confusing due to their overlap with draft articles 17(3)(l) and (m), which could be seen to created confusing different standards. The text that has been substituted is based on that previously found in footnotes 105 and 424 of A/CN.9/WG.III/WP.56, which was thought to contain preferable drafting.

⁸⁰ Drafting improvements have been made to clarify the text of this draft article as set out in A/CN.9/WG.III/WP.56, but to keep its meaning intact.

⁸¹ The phrase "[fitted to carry cargo on deck]" has been deleted as redundant.

⁸² The square brackets that were formerly around the phrase "the contract of carriage, or" have been deleted, since they were added pending consideration by the Working Group of freedom of contract issues, pursuant to paragraph 106 of A/CN.9/552, and this consideration has already occurred.

⁸³ As discussed at paras. 108 and 109 of A/CN.9/552, para. 2 may need to be discussed in greater detail in conjunction with draft para. 17(6), however, changes to para. 17(6) may have rendered this discussion unnecessary.

4. The carrier is not entitled to invoke subparagraph 1(c) of this article against a third party that has acquired a negotiable transport document or a negotiable electronic transport record in good faith, unless the contract particulars state that the goods may be carried on deck.⁸⁴

[5. If the carrier and shipper [expressly] agreed that the goods would be carried under deck, the carrier is not entitled to limit its liability for any loss of, damage to or delay in the delivery of the goods [[that solely][to the extent that such damage] resulted from their carriage on deck]⁸⁵.]⁸⁶

*Article 26. Carriage preceding or subsequent to sea carriage*⁸⁷

1. When loss of or damage to goods, or an event or circumstances causing a delay in their delivery, occurs during the carrier's period of responsibility but solely before their loading onto the ship or solely after their discharge from the ship, the provisions of this Convention do not prevail over those provisions of another international instrument⁸⁸ [or national law] that, at the time of such loss, damage or event or circumstance causing delay:

(a) [Variant A of subparagraph (a): Pursuant to the provisions of such international instrument [or national law] apply to all or any of the carrier's activities under the contract of carriage during that period;⁸⁹]

[Variant B of subparagraph (a): Pursuant to the provisions of such international instrument [or national law] would have applied to all or any of the carrier's activities if the shipper had made a separate and direct contract with the carrier in respect of the particular stage of carriage where the loss of, or damage to goods, or an event or circumstance causing delay in their delivery occurred;⁹⁰]

(b) Specifically provide for the carrier's liability, limitation of liability, or time for suit; and

⁸⁴ As discussed at paras. 110 and 111 of A/CN.9/552, discussion of this paragraph, which formerly appeared as draft article 26(3) in A/CN.9/WG.III/WP.56, and whether it should cover third-party reliance on non-negotiable transport documents and electronic transport records would continue after discussion of third-party rights and freedom of contract.

⁸⁵ As decided at paras. 113-114 and 117 of A/CN.9/552, square brackets were placed around "that exclusively resulted from their carriage on deck". A further alternative has been added.

⁸⁶ As decided at paras. 116 and 117 of A/CN.9/552, square brackets were placed around para. 5, for discussion at a future session, with further study of its relationship with draft art. 64.

⁸⁷ The redrafted text of draft paragraph 1 of this article from the text as set out in A/CN.9/WG.III/WP.56 is intended as improved drafting only, and is not intended to change the content of the provision in any way.

⁸⁸ The word "convention" has been changed to "instrument" here and in subparas. 1(a) and (c) in order to include the mandatory regulations of regional organizations.

⁸⁹ Variant A is the text of former draft article 27(1)(b)(i) as it appeared in A/CN.9/WG.III/WP.56, with slight drafting improvements. Further, as set out in para. 55 of A/CN.9/WG.III/WP.21, the bracketed text "[irrespective whether the issuance of any particular document is needed in order to make such international convention applicable]" reflected the situation under the 1980 Convention concerning International Carriage by Rail ("COTIF"). Since the 1999 Protocol for the Modification of COTIF entered into force in July 2006, the bracketed text has been deleted in both Variants.

⁹⁰ Variant B is based upon the drafting suggestion set out in para. 224 of A/CN.9/616 and agreed at para. 228.

(c) Cannot be departed from by contract⁹¹ either at all or to the detriment of the shipper under that instrument [or national law].

[2. Paragraph 1 of this article does not affect the application of article 62, paragraph 2.⁹²]

[3. Except where otherwise provided in [paragraph 1 of this article and 62, paragraph 2], the liability of the carrier and the maritime performing party for loss of or damage to the goods, or for delay, shall be solely governed by the provisions of this Convention.⁹³]

CHAPTER 8. OBLIGATIONS OF THE SHIPPER TO THE CARRIER

*Article 27. Delivery for carriage*⁹⁴

1. Unless otherwise agreed in the contract of carriage, the shipper shall deliver the goods ready for carriage. In any event, the shipper shall deliver the goods in such condition that they will withstand the intended carriage, including their loading, handling, stowing, lashing and securing, and discharging, and that they will not cause harm to persons or property.

[2. When the carrier and the shipper have made an agreement referred to in article 14, paragraph 2, the shipper shall properly and carefully load, handle, stow or discharge the goods.]

3. When a container or trailer is packed by the shipper, the shipper shall properly and carefully stow, lash and secure the contents in or on the container or trailer and in such a way that they will not cause harm to persons or property.

Article 28. Obligation of the shipper and the carrier to provide information and instructions

Without prejudice to the shipper's obligations in article 30, the carrier and the shipper shall respond to requests from each other to provide information and instructions required for the proper handling and carriage of the goods, if the information is in the requested party's possession or the instructions are within the requested party's reasonable ability to provide and they are not otherwise reasonably available to the requesting party.⁹⁵

⁹¹ The word "private" has been deleted from before the word "contract" as redundant.

⁹² If para. 62(2) is deleted, this paragraph should also be deleted.

⁹³ Paragraph 3 as it appeared in A/CN.9/WG.III/WP.56 has been replaced with the text set out in paragraph 36 of A/CN.9/WG.III/WP.78, as considered by the Working Group in paragraphs 233 and 235 of A/CN.9/616. Although the text of this paragraph has changed, it is intended to fulfil the same purpose as the previous text, which was, as set out in para. 54 of A/CN.9/WG.III/WP.21, as a conflict of law provision that was intended to safeguard the applicability of inland transport conventions.

⁹⁴ Revised text intended to simplify the text of this article (see paras. 113 and 120 of A/CN.9/591), taking into account the text in footnotes 116 and 435 of A/CN.9/WG.III/WP.56, and to clarify that draft para. 1 refers to the condition of the goods themselves and to their packaging, while draft paras. 2 and 3 refer to the proper stowage of the goods. Draft para. 2 takes into consideration the situation where there has been an agreement on a FIO(S) clause pursuant to draft article 14(2).

⁹⁵ Revised draft based on A/CN.9/WP.67, para. 14, Variant C, as agreed by the Working Group (A/CN.9/594, para. 186). The Working Group may wish to consider whether this draft article should be included in light of the content of draft article 29.

*Article 29. Shipper's obligation to provide information, instructions and documents*⁹⁶

1. The shipper shall provide to the carrier in a timely manner such information, instructions, and documents relating to the goods that are not otherwise reasonably available to the carrier, and that are reasonably⁹⁷ necessary:

(a) For the proper handling and carriage of the goods, including precautions to be taken by the carrier or a performing party; and

(b) For the carrier to comply with law, regulations or other requirements of public⁹⁸ authorities in connection with the intended carriage, provided that the carrier notifies the shipper in a timely manner of the information, instructions and documents it requires.

2. Nothing in this article affects any specific obligation to provide certain information, instructions and documents related to the goods pursuant to law, regulations or other requirements of public authorities in connection with the intended carriage.

Article 30. Basis of shipper's liability to the carrier

1. [Variant A of the first sentence:⁹⁹ The shipper is liable for loss¹⁰⁰ or damage sustained by the carrier[, including loss or damage caused by delay,] if the carrier proves that such loss or damage was caused by the goods¹⁰¹ or by a breach of the shipper's obligations pursuant to articles 27 and 29, subparagraphs 1(a) and (b).] [Variant B of the first sentence¹⁰²: The shipper is liable to the carrier for loss, [or] damage [or delay] caused by the breach of its obligations pursuant to articles 27 and 29, provided such loss, [or] damage [or delay] was due to the fault of the shipper or of any person referred to in article 34.] Except as provided in articles 31 and 32, the shipper is relieved of all or part of its liability if it proves that the cause or one of the causes of the loss[, or] damage [or delay] is not attributable to its fault or to the fault of any person referred to in article 34.

⁹⁶ Revised draft based on A/CN.9/WG.III/WP.69, para. 6, with elements from Variant A of A/CN.9/WG.III/WP.67, para. 20, as agreed by the Working Group (A/CN.9/594, paras. 187-194).

⁹⁷ The Working Group may wish to consider whether this second "reasonably" may be deleted, since the word "necessary" may be considered sufficient.

⁹⁸ The phrase "public authorities" has been reintroduced in paragraphs 1 and 2 of this draft article for drafting and translation purposes, and to be consistent with its use in draft article 17(3)(d).

⁹⁹ Revised draft based on the Working Group's deliberations at the 16th session (A/CN.9/591, paras. 136-153). Both Variants A and B of former paragraph 2 as it appeared in A/CN.9/WG.III/WP.56, as well as former paragraph 3, have been deleted from this draft article accordingly, and the substance of Variants A and B of paragraph 2 regarding strict liability for the provision of accurate information has been moved to a new provision in draft art. 31. The text of Variant A of para. 1 mirrors draft article 17(1).

¹⁰⁰ This loss could include loss resulting from delay.

¹⁰¹ The Working Group may wish to consider whether the phrase "caused by the goods" is appropriate in this context.

¹⁰² Variant B is taken from the text set out in para. 25 of A/CN.9/WG.III/WP.67, with the addition of the second sentence from Variant A, to facilitate the operation of draft para 2.

2. When the shipper is relieved of part of its liability pursuant to this article, the shipper is liable only for that part of the loss[, or] damage [or delay] that is attributable to its fault or to the fault of any person referred to in article 34.¹⁰³

*Article 31. Information for compilation of contract particulars*¹⁰⁴

1. The shipper shall provide to the carrier, in a timely manner, accurate information required for the compilation of the contract particulars and the issuance of the transport documents or electronic transport records, including the particulars referred to in article 37, subparagraphs 1(a), (b) and (c); the name of the party to be identified as the shipper in the contract particulars; the name of the consignee, if any; and the name of the person to whose order the transport document or electronic transport record is to be issued, if any.

2. The shipper is deemed to have guaranteed the accuracy at the time of receipt by the carrier of the information that is provided according to paragraph 1 of this article. The shipper shall indemnify the carrier against all loss, [or] damage [or delay] resulting from the inaccuracy of such information or documents.

*Article 32. Special rules on dangerous goods*¹⁰⁵

When goods by their nature or character are, [or become,] or reasonably appear likely to become, a danger to persons or property or to the environment:

(a) The shipper shall inform the carrier of the dangerous nature or character of the goods in a timely manner before the consignor delivers them to the carrier or a performing party. If the shipper fails to do so and the carrier or performing party does not otherwise have knowledge of their dangerous nature or character, the shipper is liable to the carrier for all loss, [or] damage, [or delay] and expenses resulting from [the carriage of such goods][such failure to inform] and

(b) The shipper shall mark or label dangerous goods in accordance with any law, regulations or other requirements of public authorities that apply during any stage of the intended carriage of the goods. If the shipper fails to do so, it is liable to the carrier for all loss, [or] damage, [or delay] resulting from such failure.

*Article 33. Assumption of shipper's rights and obligations by the documentary shipper*¹⁰⁶

1. A documentary shipper¹⁰⁷ is subject to the obligations and liabilities imposed on the shipper pursuant to this chapter and pursuant to article 57, and is entitled to the shipper's rights and immunities provided by this chapter and by chapter 14.

2. Paragraph 1 of this article does not affect the obligations, liabilities, rights or immunities of the shipper.

¹⁰³ Para. 2 is a new provision patterned on draft article 17(6) and is intended to ensure similar treatment of shippers and carriers in this regard.

¹⁰⁴ Removed into a separate provision from former draft article 30, subpara. (c), as set out in A/CN.9/WG.III/WP.56, as agreed by the Working Group (see A/CN.9/591, paras. 148 and 153).

¹⁰⁵ Revised draft based on text found in A/CN.9/WG.III/WP.67, para. 31, without paragraph 4, as agreed by the Working Group (A/CN.9/594, paras. 195-198).

¹⁰⁶ Revisions in this draft article as agreed in paras. 171 to 175 of A/CN.9/591.

¹⁰⁷ The first sentence of this draft paragraph as it appeared in A/CN.9/WG.III/WP.56 has been moved to draft article 1(10) as the definition of "documentary shipper."

*Article 34. Liability of the shipper for other persons*¹⁰⁸

1. The shipper is liable for the breach of its obligations under this Convention caused by the acts or omissions of any person, including employees, agents and subcontractors, to which it has entrusted the performance of any of its obligations as if such acts or omissions were its own[, but the shipper is not liable for acts or omissions of the carrier or a performing party acting on behalf of the carrier to which it has entrusted the performance of its obligations pursuant to this chapter].¹⁰⁹

[2. The shipper is liable pursuant to paragraph 1 of this article only when the act or omission of the person concerned is within the scope of that person's contract, employment or agency.]¹¹⁰

*Article 35. Cessation of shipper's liability*¹¹¹

A term in the contract of carriage according to which the liability of the shipper or any other person identified in the contract particulars as the shipper will cease, wholly or partly, upon a certain event or after a certain time is not valid:

(a) With respect to any liability pursuant to this chapter of the shipper or a person referred to in article 34; or

(b) With respect to any amounts payable to the carrier under the contract of carriage, except to the extent that the carrier has adequate security for the payment of such amounts.

[(c) To the extent that it conflicts with article 61, subparagraph (d)(iii).¹¹²]

¹⁰⁸ Revised draft based on A/CN.9/WG.III/WP.55, para. 41, as agreed by the Working Group (A/CN.9/591, paras. 178-180). As noted with respect to draft article 17(3)(h), the Working Group may wish to decide whether draft article 34 includes the "consignor" or not, and should expressly include it in draft article 34, if that is the intention.

¹⁰⁹ The bracketed text has been moved to para. 1 from its original location in para. 2 of the draft article as it appeared in A/CN.9/WG.III/WP.56, in order to mirror the text in draft article 18. The bracketed text was intended to deal with the FIO(S) issue in draft article 14(2), but the reference in draft article 17(3)(i) to actual performance of obligations by the shipper, any person referred to in art. 35 (now draft art. 34), or other parties has now been deleted in favour of the phrase "performed pursuant to an agreement in accordance with article 14, paragraph 2, unless the carrier [or a performing party] performs such activity on behalf of the shipper".

¹¹⁰ The Working Group may wish to consider whether this paragraph could be deleted as it may cause evidentiary problems in some jurisdictions where, for example, employees who have started fires with cigarettes or who have stolen cargo have been found to be acting outside of their scope of employment or contract. Deletion of the paragraph would leave the issue of what is within the scope of employment to national law. Similar treatment should be given to para. 2 of draft art. 18.

¹¹¹ Former para. 43(2) of A/CN.9/WG.III/WP.32, moved to this placement from the now-deleted chapter 9 on freight.

¹¹² Paragraph (c) could be deleted if the chapter on transfer of rights is deferred for future work.

CHAPTER 9. TRANSPORT DOCUMENTS AND ELECTRONIC TRANSPORT RECORDS

Article 36. Issuance of the transport document or the electronic transport record¹¹³

Unless the shipper and the carrier have agreed not to use a transport document or an electronic transport record, or it is the custom, usage or practice in the trade not to use one, upon delivery of the goods for carriage to the carrier or performing party:

(a) The consignor is entitled to obtain a non-negotiable transport document or, subject to article 8, subparagraph (a), a non-negotiable electronic transport record that evidences only the carrier's or performing party's receipt of the goods; and

(b) The shipper or, if the shipper consents,¹¹⁴ the documentary shipper, is entitled to obtain from the carrier, at the shipper's option, an appropriate negotiable or non-negotiable transport document or, subject to article 8, subparagraph (a), a negotiable or non-negotiable electronic transport record, unless the shipper and the carrier have agreed not to use a negotiable transport document or negotiable electronic transport record, or it is the custom, usage, or practice in the trade not to use one.¹¹⁵

Article 37. Contract particulars¹¹⁶

1. The contract particulars in the transport document or electronic transport record referred to in article 36 shall include the following information, as furnished by the shipper:

- (a) A description of the goods;
- (b) The leading marks necessary for identification of the goods;
- (c) The number of packages or pieces, or the quantity of goods; and
- (d) The weight of the goods, if furnished by the shipper.

2. The contract particulars in the transport document or the electronic transport record referred to in article 36 shall also include:

- (a) A statement of the apparent order and condition of the goods at the time the carrier or a performing party receives them for carriage;
- (b) The name and address of a person identified as¹¹⁷ the carrier;

¹¹³ Draft article amended as agreed by the Working Group (A/CN.9/594, paras. 223 and 224). Additional drafting suggestions made to clarify the application of custom, usage or practice in the trade.

¹¹⁴ The phrase "instructs the carrier" was thought to be too inflexible and too narrow, and has thus been replaced with the word "consents".

¹¹⁵ As set out in footnote 127 of A/CN.9/WG.III/WP.32, with respect to para. (a), it was acknowledged that, since not all transport documents as defined under draft art. 1(16) served the function of evidencing receipt of the goods by the carrier, it was important to make it clear that, under para. (a), the transport document should serve the receipt function.

¹¹⁶ Para. 1 of this draft article as set out in A/CN.9/WG.III/WP.56 has been redrafted as agreed by the Working Group (A/CN.9/594, paras. 225-233), and has been split into paras. 1 and 2 for greater clarity in that para. 1 concerns information furnished by the shipper.

¹¹⁷ As agreed by the Working Group at paragraphs 18 and 28 of A/CN.9/616.

(c) The date on which the carrier or a performing party received the goods, or on which the goods were loaded on board the ship, or on which the transport document or electronic transport record was issued; and

(d) The number of originals of the negotiable transport document, when more than one original is issued.

3. For the purposes of this article, the phrase “apparent order and condition of the goods” in subparagraph 2 (a) of this article refers to the order and condition of the goods based on:

(a) A reasonable external inspection of the goods as packaged at the time the shipper delivers them to the carrier or a performing party; and

(b) Any additional inspection that the carrier or a performing party actually performs before issuing the transport document or the electronic transport record.

*Article 38. Identity of the carrier*¹¹⁸

1. If the carrier is identified by name in the contract particulars, any other information in the transport document or electronic transport record relating to the identity of the carrier shall have no effect to the extent that it is inconsistent with that identification.¹¹⁹

[2. Variant A

If the contract particulars fail to identify the carrier but indicate that the goods have been loaded on board a named ship, the registered owner of the ship is presumed to be the carrier. The registered owner can defeat this presumption if it proves that the ship was under a bareboat charter at the time of the carriage that transfers contractual responsibility for the carriage of the goods to an identified bareboat charterer. [If the registered owner defeats the presumption that it is the carrier pursuant to this article, the bareboat charterer at the time of the carriage is presumed to be the carrier in the same manner as that in which the registered owner was presumed to be the carrier.]]¹²⁰

Variant B

If no person is identified in the contract particulars as the carrier as required pursuant to article 37, subparagraph 2 (b), but the contract particulars indicate that the goods have been loaded on board a named ship, the registered owner of that ship is presumed to be the carrier, unless it proves that the ship was under a bareboat charter at the time of the carriage and it identifies this bareboat charterer and indicates its address, in which case this bareboat charterer is presumed to be the carrier. Alternatively, the registered owner may

¹¹⁸ This new draft article has been inserted to draw together the provisions regarding the identity of the carrier into a single identifiable draft provision. The first paragraph of this new draft article consists of para. 4 of A/CN.9/WG.III/WP.79, while Variant A of the second paragraph consists of former draft article 40(3) as it appeared in A/CN.9/WG.III/WP.56, and Variant B of the second paragraph consists of paragraph 5 of A/CN.9/WG.III/WP.79.

¹¹⁹ This text is a modification of the text of para. 4 of A/CN.9/WG.III/WP.79, which the Working Group agreed to include in the draft convention in para. 28 of A/CN.9/616. The modification was made to ensure that the principle agreed upon by the Working Group could be applied with similar result in the case of both transport documents and electronic transport records.

¹²⁰ Variant A is the text of former draft article 40(3) as it appeared in A/CN.9/WG.III/WP.56.

rebut the presumption of being the carrier by identifying the carrier and indicating its address. The bareboat charterer may defeat any presumption of being the carrier in the same manner.^{121]}

3. Nothing in paragraph 2 of this article prevents the claimant from proving that any person other than the registered owner is the carrier.¹²²

Article 39. Signature

1. A transport document shall be signed by the carrier or a person acting on its behalf.¹²³

2. An electronic transport record shall include the electronic signature of the carrier or a person acting on its behalf.¹²⁴ Such electronic signature shall identify the signatory in relation to the electronic transport record and indicate the carrier's authorization of the electronic transport record.

Article 40. Deficiencies in the contract particulars

1. The absence of one or more of the contract particulars referred to in article 37, paragraphs 1 or 2, or the inaccuracy of one or more of those particulars, does not of itself affect the legal character or validity of the transport document or of the electronic transport record.

2. If the contract particulars include the date but fail to indicate its significance, the date is deemed¹²⁵ to be:

(a) The date on which all of the goods indicated in the transport document or electronic transport record were loaded on board the ship,¹²⁶ if the contract particulars indicate that the goods have been loaded on board a ship; or

(b) The date on which the carrier or a performing party received the goods,¹²⁷ if the contract particulars do not indicate that the goods have been loaded on board a ship.

3. If the contract particulars fail to state the apparent order and condition of the goods at the time the carrier or a performing party receives them from the consignor, the contract particulars are deemed to have stated¹²⁸ that the goods were

¹²¹ Variant B is based on the text suggested in paragraph 5 of A/CN.9/WG.III/WP.79.

¹²² The Working Group may wish to consider the inclusion of a provision such as this to ensure that cargo interests remain free to advance their claims against the carrier they believed to be responsible for the loss or damage, as supported by the Working Group in paragraphs 23 and 28 of A/CN.9/616.

¹²³ Although the Working Group agreed at paras. 12 and 13 of A/CN.9/616 to substitute the phrase "by or on behalf of the carrier" for the phrase "by the carrier or a person having authority from the carrier", the Working Group may wish to consider whether the drafting suggested more effectively achieves its goal of leaving issues such as agency and proper authority to the applicable law. The drafting formulation suggested is the same as that taken in article 15(1)(j) of the Hamburg Rules.

¹²⁴ Ibid.

¹²⁵ Text changed from "considered" to "deemed" to render it more conclusive as agreed by the Working Group in paras. 16 and 28 of A/CN.9/616.

¹²⁶ This drafting suggestion to reverse the order of the two phrases as they existed in the previous text is intended to improve the clarity of the subparagraph.

¹²⁷ Ibid.

¹²⁸ While draft para. 3 was approved in substance (see para. 26 of A/CN.9/616), a drafting clarification has been made to the text to ensure conformity with the changes made to draft

in apparent good order and condition at the time the consignor delivered them to the carrier or a performing party.¹²⁹

*Article 41. Qualifying the description of the goods in the contract particulars*¹³⁰

1. The carrier may qualify the information referred to in article 37, subparagraphs 1(a), (b), (c) or (d) in the circumstances and in the manner set out in this article in order to indicate that the carrier does not assume responsibility for the accuracy of the information furnished by the shipper, and shall do so if:

(a) The carrier has actual knowledge that any material statement in the transport document or electronic transport record is materially false or misleading; or

(b) The carrier reasonably believes that a material statement in the transport document or electronic transport record is false or misleading.¹³¹

2. When the goods are not delivered for carriage to the carrier or a performing party in a closed container, the carrier may qualify the information referred to in article 37, subparagraphs 1(a), (b), (c) or (d) if:

(a) The carrier had no physically practicable or commercially¹³² reasonable means of checking the information furnished by the shipper, in which case it may indicate which information it was unable to check; or

(b) The carrier reasonably considers the information furnished by the shipper to be inaccurate, in which case it may include a clause providing what it reasonably considers accurate information.

3. When the goods are delivered for carriage to the carrier or a performing party in a closed container, the carrier may include a qualifying clause in the contract particulars with respect to:

(a) The information referred to in article 37, subparagraphs 1(a), (b), or (c), if:

(i) Neither the carrier nor a performing party has in fact inspected the goods inside the container; or

(ii) Neither the carrier nor a performing party otherwise has actual knowledge of its contents before issuing the transport document or the electronic transport record;

article 42 and to take into account the approach taken in article 16(2) of the Hamburg Rules.

¹²⁹ The Working Group may wish to consider whether reference should be made in this article to the number of original bills of lading now required in the contract particulars pursuant to draft article 37(2)(d).

¹³⁰ The draft article has been reformulated to simplify and better align its structure and to take into account the issues raised in A/CN.9/WG.III/WP.62, paras. 36-39, and the deliberations at the Working Group's eighteenth session (A/CN.9/616, paras. 29-39).

¹³¹ As agreed by the Working Group (paras. 35-37, 39, 41 and 43-44, A/CN.9/616).

¹³² The phrase "the carrier can show that" has been deleted here and in draft paras. 4(a) and (b) pursuant to the decision of the Working Group (para. 38, A/CN.9/616). Further, the phrase "physically practicable or commercially" has been included here to allow for the deletion of former draft article 42(a), as it appeared in A/CN.9/WG.III/WP.56, as agreed by the Working Group (paras. 43-44, A/CN.9/616).

- (b) The information referred to in article 37, subparagraph 1(d), if:
 - (i) Neither the carrier nor a performing party weighed the container, and the shipper and the carrier had not agreed prior to the shipment that the container would be weighed and the weight would be included in the contract particulars; or
 - (ii) There was no physically practicable or commercially¹³³ reasonable means of checking the weight of the container.

*Article 42. Evidentiary effect of the contract particulars*¹³⁴

Except to the extent that the contract particulars have been qualified in the circumstances and in the manner set out in article 41:¹³⁵

(a) A transport document or an electronic transport record that evidences receipt of the goods is prima facie evidence of the carrier's receipt of the goods as stated in the contract particulars;¹³⁶

(b) Proof to the contrary by the carrier in respect of any contract particulars shall not be admissible, when such contract particulars are included in:

- (i) A negotiable transport document or a negotiable electronic transport record that is transferred to a third party acting in good faith, or
- (ii) A non-negotiable transport document or a non-negotiable electronic transport record that indicates that it must be surrendered in order to obtain delivery of the goods and is transferred to the consignee acting in good faith.¹³⁷

(c) Proof to the contrary by the carrier shall not be admissible against a consignee acting in good faith in respect of contract particulars referred to in article 37, subparagraph 2 (a) included in a non-negotiable transport document or a non-negotiable electronic transport record, when such contract particulars are furnished by the carrier. For the purpose of this paragraph, the information referred to in article 37, subparagraph 2 (a), as well as the number, type and identifying numbers of the containers, but not the identifying numbers of the container seals, is deemed to be information furnished by the carrier.¹³⁸

¹³³ The phrase "physically practicable or commercially" has been included here to allow for the deletion of former draft article 42(a), as it appeared in A/CN.9/WG.III/WP.56, as agreed by the Working Group (paras. 43-44, A/CN.9/616).

¹³⁴ The drafting adjustments to the text are made to the provision as it appeared in para. 58 of A/CN.9/616.

¹³⁵ The contents of the chapeau of draft article 42 was located in former draft article 44, as it appeared in A/CN.9/WG.III/WP.56, which has been deleted.

¹³⁶ The Working Group may wish to note that this paragraph represents an expansion of the coverage of this principle from that set out in article IV(5)(f) of the Hague-Visby Rules.

¹³⁷ This subparagraph has been reformulated to avoid the difficult notion of conclusive evidence by using the construction of article 16(3)(b) of the Hamburg Rules, which has, however, been expanded to include non-negotiable transport documents and electronic transport records.

¹³⁸ The clarifications made to draft para. (c) as compared with the version of the text that appeared in para. 58 of A/CN.9/616 are those agreed to by the Working Group in para. 59 of A/CN.9/616.

*Article 43. "Freight prepaid"*¹³⁹

If the contract particulars¹⁴⁰ contain the statement "freight prepaid" or a statement of a similar nature, the carrier cannot assert against the holder or the consignee the fact that the freight has not been paid.¹⁴¹ This article does not apply if the holder or the consignee is also the shipper.

CHAPTER 10. DELIVERY OF THE GOODS

Article 44. Obligation to accept delivery

When the goods have arrived at their destination, the consignee that [exercises any of its rights under][has actively involved itself in] the contract of carriage¹⁴² shall accept delivery of the goods at the time and location referred to in article 11, paragraph 2.

Article 45. Obligation to acknowledge receipt

On request of the carrier or the performing party that delivers the goods, the consignee shall acknowledge receipt¹⁴³ of the goods from the carrier or the performing party in the manner that is customary at the place of delivery. The carrier may refuse delivery if the consignee refuses to acknowledge such receipt.

*Article 46. Delivery when no negotiable transport document or negotiable electronic transport record is issued*¹⁴⁴

When no negotiable transport document or no negotiable electronic transport record has been issued:

(a) The carrier shall deliver the goods to the consignee at the time and location referred to in article 11, paragraph 2. The carrier may refuse delivery if the person claiming to be the consignee does not properly identify itself as the consignee on the request of the carrier.

(b) If the name and address of the consignee are not referred to in the contract particulars, the controlling party shall prior to or upon the arrival of the goods at the place of destination advise the carrier of such name and address.

(c) If the name or the address of the consignee is not known to the carrier or if the consignee, after having received a notice of arrival, does not claim delivery of

¹³⁹ Former draft para. 44(1) from A/CN.9/WG.III/WP.32 retained as agreed (see paras. 162 to 164 of A/CN.9/552) in draft art. 43.

¹⁴⁰ The phrase "in a negotiable transport document or a negotiable electronic transport record" has been deleted in order to render the provision neutral as between negotiable and non-negotiable documents, as agreed by the Working Group (paras. 81-82, A/CN.9/616).

¹⁴¹ As agreed by the Working Group (para. 80, A/CN.9/616), the text suggested in para. 59 of A/CN.9/WG.III/WP.62 has been included in the provision.

¹⁴² As set out in footnote 160 of A/CN.9/WG.III/WP.32, a preference was expressed for the obligation to accept delivery not to be made dependent upon the exercise of any rights by the consignee, but rather that it be unconditional.

¹⁴³ It was thought that deletion of the phrase "shall confirm delivery" and replacement with the phrase "must acknowledge receipt" was preferable since the consignee could confirm its own act, but not the fulfilment of the carrier's obligation.

¹⁴⁴ Revised text as agreed by the Working Group (A/CN.9/591, paras. 226 and 230), but with the order of paras. (a) and (b) reversed from their former position in the draft article in A/CN.9/WG.III/WP.56.

the goods from the carrier after their arrival at the place of destination, the carrier shall so advise the controlling party or, if, after reasonable effort, it is unable to locate the controlling party, the shipper. In such event, the controlling party or shipper shall give instructions in respect of the delivery of the goods. If the carrier is unable, after reasonable effort, to locate the controlling party or the shipper, the documentary shipper is deemed to be the shipper for purposes of this paragraph.

(d) The carrier that delivers the goods upon instruction of the controlling party or the shipper pursuant to subparagraph (c) of this article is discharged from its obligations to deliver the goods under the contract of carriage.¹⁴⁵

[Article 47. Delivery when a non-negotiable transport document that requires surrender is issued¹⁴⁶

When a non-negotiable transport document has been issued that [provides] [indicates] [specifies] that it shall be surrendered in order to obtain delivery of the goods:

(a) The carrier shall deliver the goods at the time and location referred to in article 11, paragraph 2 to the consignee upon proper identification of it on the request of the carrier and surrender of the non-negotiable document. The carrier may refuse delivery if the person claiming to be the consignee fails to properly identify itself on the request of the carrier, and shall refuse delivery if the non-negotiable document is not surrendered. If more than one original of the non-negotiable document has been issued, the surrender of one original will suffice and the other originals cease to have any effect or validity.

(b) If the consignee does not claim delivery of the goods from the carrier after their arrival at the place of destination or the carrier refuses delivery because the person claiming to be the consignee does not properly identify itself as the consignee or does not surrender the document, the carrier shall so advise the shipper. In such event, the shipper shall give instructions in respect of delivery of the goods. If the carrier, after reasonable effort, is unable to locate the shipper, the documentary shipper is deemed to be the shipper for the purpose of this paragraph.

(c) The carrier that delivers the goods upon instruction of the shipper pursuant to subparagraph (b) of this article is discharged from its obligation to deliver the goods under the contract of carriage, irrespective of whether the non-negotiable transport document has been surrendered to it.^{147]}

¹⁴⁵ Paragraph (d) of this draft article consists of the final sentence of former paragraph (c) of this draft article, but it has been placed in a separate paragraph to be consistent with the treatment of the similar paragraph in draft article 49.

¹⁴⁶ Draft article based on proposed new article 48 bis as set out in A/CN.9/WG.III/WP.68, para. 15, with slight drafting adjustments, which the Working Group agreed to include in the draft convention (A/CN.9/594, paras. 208-215).

¹⁴⁷ Paragraph (c) of this draft article consists of the final sentence of former paragraph (b) of this draft article as it appeared in A/CN.9/WG.III/WP.68, para. 15, but it has been placed in a separate paragraph to be consistent with the treatment of the similar paragraph in draft article 49.

[Article 48. Delivery when a non-negotiable electronic transport record that requires surrender is issued]¹⁴⁸

When a non-negotiable electronic transport record has been issued that [provides] [indicates] [specifies] that it shall be surrendered in order to obtain delivery of the goods:

(a) The carrier shall deliver the goods at the time and location referred to in article 11, paragraph 2 to the person named in the electronic record as the consignee and that has exclusive control of the electronic record. Upon such delivery the electronic record ceases to have any effect or validity. The carrier may refuse delivery if the person claiming to be the consignee does not properly identify itself as the consignee on the request of the carrier, and shall refuse delivery if the person claiming to be the consignee is unable to demonstrate in accordance with the procedures referred to in article 9 that it has exclusive control of the electronic record.

(b) If the consignee does not claim delivery of the goods from the carrier after their arrival at the place of destination or the carrier refuses delivery in accordance with subparagraph (a) of this article, the carrier shall so advise the shipper. In such event, the shipper shall give instructions in respect of delivery of the goods. If the carrier, after reasonable effort, is unable to locate the shipper, the documentary shipper is deemed to be the shipper for the purpose of this paragraph.

(c) The carrier that delivers the goods upon instruction of the shipper pursuant to subparagraph (b) of this article is discharged from its obligation to deliver the goods under the contract of carriage, irrespective of whether the person to which the goods are delivered is able to demonstrate in accordance with the procedures referred to in article 9 that it has exclusive control of the electronic record.^{149]}

Article 49. Delivery when a negotiable transport document or negotiable electronic transport record is issued¹⁵⁰

When a negotiable transport document or a negotiable electronic transport record has been issued:

(a) Without prejudice to article 44, the holder of the negotiable transport document or negotiable electronic transport record is entitled to claim delivery of the goods from the carrier after they have arrived at the place of destination, in which event the carrier shall deliver the goods at the time and location referred to in article 11, paragraph 2, to the holder, as appropriate:

¹⁴⁸ Draft article based on proposed new article 48 ter as set out in A/CN.9/WG.III/WP.68, para. 16, with slight drafting adjustments, which the Working Group agreed to include in the draft convention (A/CN.9/594, paras. 208-215).

¹⁴⁹ Paragraph (c) of this draft article consists of the final sentence of former paragraph (b) of this draft article as it appeared in A/CN.9/WG.III/WP.68, para. 16, but it has been placed in a separate paragraph to be consistent with the treatment of the similar paragraph in draft article 49.

¹⁵⁰ Revised text as agreed by the Working Group (A/CN.9/591, paras. 231-239, and A/CN.9/595, paras. 80-89). As a drafting improvement to avoid repetition, former subparas. (a)(i) and (ii) as set out in A/CN.9/WG.III/WP.56 have been combined to form paras. (a) and (b) in this article.

- (i) Upon surrender of the negotiable transport document and, if the holder is one of the persons referred to in article 1, subparagraph 12(a)(i), upon proper identification; or
 - (ii) Upon demonstration by the holder, in accordance with the procedures referred to in article 9, subparagraph 1(c), that it is the holder of the negotiable electronic transport record.
- (b). The carrier shall refuse delivery if the conditions of subparagraph (a)(i) or (a)(ii) are not met.
- (c) If more than one original of the negotiable transport document has been issued, the surrender of one original will suffice and the other originals cease to have any effect or validity. When a negotiable electronic transport record has been used, such electronic transport record ceases to have any effect or validity upon delivery to the holder in accordance with the procedures required by article 9, subparagraph 1(d).
- (d) If the holder does not claim delivery of the goods from the carrier after their arrival at the place of destination, the carrier shall so advise the controlling party or, if, after reasonable effort, it is unable to locate the controlling party, the shipper. In such event the controlling party or shipper shall give the carrier instructions in respect of the delivery of the goods. If the carrier is unable, after reasonable effort, to locate the controlling party or the shipper, the documentary shipper shall be deemed to be the shipper for purposes of this paragraph.
- (e) The carrier that delivers the goods upon instruction of the controlling party or the shipper in accordance with subparagraph (d) of this article is discharged from its obligation to deliver the goods under the contract of carriage to the holder, irrespective of whether the negotiable transport document has been surrendered to it, or the person claiming delivery under a negotiable electronic transport record has demonstrated, in accordance with the procedures referred to in article 9, that it is the holder.
- (f) A person that becomes a holder of the negotiable transport document or the negotiable electronic transport record after the carrier has delivered the goods pursuant to subparagraph (e) of this article, but pursuant to contractual or other arrangements made before such delivery acquires rights against the carrier under the contract of carriage, other than the right to claim delivery of the goods.
- (g) Notwithstanding subparagraphs (e) and (f) of this article, the holder that did not have or could not reasonably have had knowledge of such delivery at the time it became a holder acquires the rights incorporated in the negotiable transport document or negotiable electronic transport record.

Article 50. Goods remaining undelivered

1. Unless otherwise agreed and without prejudice to any other rights that the carrier may have against the shipper, controlling party or consignee,¹⁵¹ if the goods have remained undelivered, the carrier may, at the risk and expense of the

¹⁵¹ Former draft article 50 as set out in A/CN.9/WG.III/WP.56 has been deleted, and its substance incorporated into draft article 50 in this text, in light of the Working Group's deliberations at the 17th session (A/CN.9/594, paras. 90-93). See also subpara. 2(b) of this article.

person entitled to the goods, take such action in respect of the goods as circumstances may reasonably require, including:¹⁵²

- (a) To store the goods at any suitable place;
- (b) To unpack the goods if they are packed in containers, or to act otherwise in respect of the goods, including by moving the goods or causing them to be destroyed; and
- (c) To cause the goods to be sold in accordance with the practices, or pursuant to the law or regulations of the place where the goods are located at the time.

2. For the purposes of this article, goods shall be deemed to have remained undeliverable if, after their arrival at the place of destination:¹⁵³

- (a) The consignee does not accept delivery of the goods pursuant to this chapter at the time and location referred to in article 11, paragraph 2;
- (b) The controlling party or the shipper cannot be found or does not give the carrier adequate instructions pursuant to articles 46, 47, 48 and 49;
- (c) The carrier is entitled or required to refuse delivery pursuant to articles 46, 47, 48 and 49;¹⁵⁴
- (d) The carrier is not allowed to deliver the goods to the consignee pursuant to the law or regulations of the place at which delivery is requested; or
- (e) The goods are otherwise undeliverable by the carrier.

3. The carrier may exercise these rights only after it has given reasonable advance notice of arrival of the goods at the place of destination to the person stated in the contract particulars as the person if any, to be notified of the arrival of the goods at the place of destination, and to one of the following persons in the order indicated, if known to the carrier: the consignee, the controlling party or the shipper.¹⁵⁵

4. If the goods are sold pursuant to subparagraph 1(c) of this article, the carrier shall hold the proceeds of the sale for the benefit of the person entitled to the goods, subject to the deduction of any costs incurred by the carrier and any other amounts that are due to the carrier in connection with the carriage of those goods.¹⁵⁶

¹⁵² Paragraph 1 is a slightly amended version of former draft art. 51(2) as set out in A/CN.9/WG.III/WP.56, with amendments and corresponding changes to the chapeau as per deliberations of the Working Group (A/CN.9/594, paras. 97 to 99).

¹⁵³ Paragraph 2 is a slightly amended version of former draft art. 51(1)(a) as set out in A/CN.9/WG.III/WP.56, with amendments and corresponding changes to the chapeau as per deliberations of the Working Group (A/CN.9/594, paras. 96 and 99).

¹⁵⁴ The Working Group may wish to consider the addition of subpara. 2(c) in order to include the situation when the goods remain undelivered because the carrier is entitled or required to refuse delivery.

¹⁵⁵ Paragraph 3 reflects the incorporation into draft article 50 of former article 52 as set out in A/CN.9/WG.III/WP.56, which the Working Group wished to see placed earlier in the text (A/CN.9/594, paras. 102-106).

¹⁵⁶ This paragraph was formerly draft art. 51(3) of the text as set out in A/CN.9/WG.III/WP.56, with slight modifications to reflect the views of the Working Group (A/CN.9/594, paras. 100-101).

5. The carrier shall not be liable for loss of or damage to goods that remain undelivered pursuant to this article unless the claimant proves that such loss or damage resulted from the failure by the carrier to take steps that would have been reasonable in the circumstances to preserve the goods and that the carrier knew or ought to have known that the loss or damage to the goods would result from its failure to take such steps.¹⁵⁷

*Article 51. Retention of goods*¹⁵⁸

Nothing in this Convention affects a right of the carrier or a performing party that may exist pursuant to the contract of carriage or the applicable law to retain the goods to secure the payment of sums due.

CHAPTER 11. RIGHTS OF THE CONTROLLING PARTY¹⁵⁹

*Article 52. Exercise and extent of right of control*¹⁶⁰

1. The right of control may be exercised only by the controlling party and is limited to:

(a) The right to give or modify instructions in respect of the goods that do not constitute a variation of the contract of carriage;

(b) The right to obtain delivery of the goods at a scheduled port of call or, in respect of inland carriage, any place en route; and

(c) The right to replace the consignee by any other person including the controlling party.

2. The right of control exists during the entire period of responsibility of the carrier, as provided in article 11, paragraph 1.

Article 53. Identity of the controlling party and transfer of the right of control

1. When no negotiable transport document or no negotiable electronic transport record is issued:¹⁶¹

(a) The shipper is the controlling party unless the shipper, when the contract of carriage is concluded, designates the consignee, the documentary shipper or another person as the controlling party;

(b) The controlling party is entitled to transfer the right of control to another person. The transfer becomes effective with respect to the carrier upon its

¹⁵⁷ This draft paragraph consists of a combination of the second sentence of former draft art. 46 and of the spirit of former draft art. 53, both as set out in A/CN.9/WG.III/WP.56, and revised so as to reflect the Working Group's deliberations (A/CN.9/594, paras. 107-113). The Secretariat suggests that placement of the revised provision would be best in this draft article.

¹⁵⁸ This new draft paragraph is based on the text contained in para. 14 of A/CN.9/WG.III/WP.63 and reflects the Working Group's deliberations (A/CN.9/594, paras. 114-117).

¹⁵⁹ Title of the chapter revised to better reflect its content.

¹⁶⁰ Revised draft as agreed by the Working Group (A/CN.9/594, paras. 10-16), with drafting alterations to reflect that the definition of "controlling party" has been placed in draft article 1(15).

¹⁶¹ Revised draft as agreed by the Working Group (A/CN.9/594, paras. 23-36 and 68-71). Former draft article 56(1)(d) as set out in A/CN.9/WG.III/WP.56 has been moved to become a separate para. 5 of this article.

notification of the transfer by the transferor, and the transferee becomes the controlling party;

(c) The controlling party shall produce proper identification when it exercises the right of control.

2. When a non-negotiable transport document or a non-negotiable electronic transport record has been issued that [provides] [indicates] [specifies] that it shall be surrendered in order to obtain delivery of the goods:

(a) The shipper is the controlling party and may transfer the right of control to the consignee named in the transport document or the electronic transport record by transferring the document to this person without endorsement, or by transferring the electronic transport record to it in accordance with the procedures referred to in article 9. If more than one original of the document was issued, all originals shall be transferred in order to effect a transfer of the right of control;

(b) In order to exercise its right of control, the controlling party shall produce the document and proper identification, or, in the case of an electronic transport record, shall demonstrate in accordance with the procedures referred to in article 9 that it has exclusive control of the electronic transport record. If more than one original of the document was issued, all originals shall be produced, failing which the right of control cannot be exercised.

3. When a negotiable transport document is issued:

(a) The holder or, if more than one original of the negotiable transport document is issued, the holder of all originals is the controlling party;

(b) The holder may transfer the right of control by transferring the negotiable transport document to another person in accordance with article 59. If more than one original of that document was issued, all originals shall be transferred in order to effect a transfer of the right of control;

(c) In order to exercise the right of control, the holder shall produce the negotiable transport document to the carrier, and if the holder is one of the persons referred to in article 1, subparagraph 12(a)(i), the holder shall produce proper identification. If more than one original of the document was issued, all originals shall be produced, failing which the right of control cannot be exercised.¹⁶²

4. When a negotiable electronic transport record is issued:

(a) The holder is the controlling party;

(b) The holder may transfer the right of control to another person by transferring the negotiable electronic transport record in accordance with the procedures referred to in article 9;

(c) In order to exercise the right of control, the holder shall demonstrate, in accordance with the procedures referred to in article 9, that it is the holder.¹⁶³

5. The right of control ceases when the goods have arrived at destination and have been delivered in accordance with this Convention.¹⁶⁴

¹⁶² Revised draft as agreed by the Working Group (A/CN.9/594, paras. 37-40).

¹⁶³ Revised draft as agreed by the Working Group (A/CN.9/594, para. 41).

¹⁶⁴ Revised draft as agreed by the Working Group (A/CN.9/594, paras. 23-36 and 68-71). This

[6. Notwithstanding article 61, a person, not being the shipper or the documentary shipper, that transferred the right of control without having exercised that right, is upon such transfer discharged from the liabilities imposed on the controlling party by the contract of carriage or by this Convention.]¹⁶⁵

Article 54. Carrier's execution of instructions

1. Subject to paragraphs 2 and 3 of this article, the carrier shall execute the instructions referred to in article 52 if:¹⁶⁶

(a) The person giving such instructions is entitled to exercise the right of control;

(b) The instructions can reasonably be executed according to their terms at the moment that they reach the carrier; and

(c) The instructions will not interfere with the normal operations of the carrier, including its delivery practices.

2. In any event, the controlling party shall reimburse the carrier any additional expense that the carrier may incur and shall indemnify the carrier against any loss or damage that the carrier may suffer as a result of executing any instruction pursuant to this article, including compensation that the carrier may become liable to pay for loss of or damage to [or for delay in delivery of] other goods being carried.¹⁶⁷

3. The carrier is entitled to obtain security from the controlling party for the amount of additional expense, loss or damage that the carrier reasonably expects will arise in connection with the execution of an instruction pursuant to this article. The carrier may refuse to carry out the instructions if no such security is provided.

4. The carrier's liability for loss of or damage to the goods [or for delay in delivery] resulting from its failure to comply with the instructions of the controlling party in breach of its obligation pursuant to paragraph 1 of this article shall be subject to articles 17 to 23, and the amount of the compensation payable by the carrier shall be subject to articles 62 to 64.¹⁶⁸

Article 55. Deemed delivery

Goods that are delivered pursuant to an instruction in accordance with article 52, subparagraph 1(b), are deemed to be delivered at the place of destination, and the provisions of chapter 10 relating to such delivery apply to such goods.

paragraph was formerly draft para. 56(1)(d) as set out in A/CN.9/WG.III/WP.56, and has been moved to this placement to improve clarity.

¹⁶⁵ Revised draft as agreed by the Working Group (A/CN.9/594, paras. 42-45). The Working Group agreed that this paragraph should be placed in square brackets pending its possible modification or deletion, following further consideration of the issues raised and of the text in draft para. 60(1).

¹⁶⁶ Revised draft as agreed by the Working Group (A/CN.9/594, paras. 46-49).

¹⁶⁷ Revised draft as agreed by the Working Group (A/CN.9/594, paras. 50-51).

¹⁶⁸ New provision replacing former article 57(4), as it appeared in A/CN.9/WG.III/WP.56, as requested by the Working Group (A/CN.9/594, paras. 55-58).

*Article 56. Variations to the contract of carriage*¹⁶⁹

1. The controlling party is the only person that may agree with the carrier to variations to the contract of carriage other than those referred to in article 52, subparagraphs 1(b) and (c).

2. Variations to the contract of carriage, including those referred to in article 52, subparagraphs 1(b) and (c), shall be stated in a negotiable transport document or incorporated in a negotiable electronic transport record, or, at the option of the controlling party, shall be stated in a non-negotiable transport document or incorporated in a non-negotiable electronic transport record.¹⁷⁰ If so stated or incorporated, such variations shall be signed in accordance with article 39.

3. Variations to the contract of carriage made pursuant to this article shall not affect the rights and obligations of the parties prior to the date on which they are signed in accordance with article 39.

Article 57. Providing additional information, instructions or documents to carrier

If the carrier or a performing party during the period that it has custody of the goods reasonably requires information, instructions, or documents in addition to those referred to in article 29, subparagraph 1(a), the controlling party, on request of the carrier or such performing party, shall provide such information, instructions or documents to the extent that it is able to do so. If the carrier, after reasonable effort, is unable to locate the controlling party or the controlling party is unable to provide adequate information, instructions, or documents to the carrier, the shipper or the documentary shipper shall do so.¹⁷¹

Article 58. Variation by agreement

The parties to the contract of carriage may vary the effect of articles 52, subparagraphs 1(b) and (c), 53, paragraph 5 and 54. The parties may also restrict or exclude the transferability of the right of control referred to in article 53, subparagraph 1(b).¹⁷²

¹⁶⁹ Draft article moved here from its previous placement as former draft article 55 earlier in the chapter as set out in A/CN.9/WG.III/WP.56. Revised draft of provision as agreed by the Working Group (A/CN.9/594, paras. 17-22).

¹⁷⁰ The non-negotiable transport document and electronic transport record that require surrender in draft articles 47 and 48 should be included here should the Working Group decide that they will constitute conclusive evidence.

¹⁷¹ The Working Group at para 63 of A/CN.9/594 suggested that a difference could be drawn based on whether the controlling party has been active or passive. However, the Secretariat suggests that this may be unnecessary, since the controlling party should always be aware if it is a controlling party, and text as it stands indicates other parties who may be contacted for additional information if the controlling party is not identified or found.

¹⁷² The Secretariat suggests the deletion of the following closing phrase as redundant: "If a negotiable transport document or a negotiable electronic transport record is issued, any agreement referred to in this article shall be stated or incorporated in the contract particulars."

[CHAPTER 12. TRANSFER OF RIGHTS¹⁷³*Article 59. When a negotiable transport document or negotiable electronic transport record is issued*

1. When a negotiable transport document is issued, the holder may transfer the rights incorporated in the document by transferring it to another person:

(a) If an order document, duly endorsed either to such other person or in blank; or,

(b) If a bearer document or a blank endorsed document, without endorsement; or,

(c) If a document made out to the order of a named person and the transfer is between the first holder and the named person, without endorsement.¹⁷⁴

2. When a negotiable electronic transport record is issued, its holder may transfer the rights incorporated in it, whether it be made out to order or to the order of a named person, by transferring the electronic transport record in accordance with the procedures referred to in article 9.¹⁷⁵

Article 60. Liability of holder

1. Without prejudice to article 57, a holder that is not the shipper and that does not exercise any right under the contract of carriage does not assume any liability under the contract of carriage solely by reason of being a holder.

2. A holder that is not the shipper and that exercises any right under the contract of carriage assumes [any liabilities imposed on it under the contract of carriage to the extent that such liabilities are incorporated in or ascertainable from the negotiable transport document or the negotiable electronic transport record] [the liabilities imposed on the controlling party pursuant to chapter 11 and the liabilities imposed on the shipper for the payment of freight, dead freight, demurrage and compensation for detention to the extent that such liabilities are incorporated in the negotiable transport document or the negotiable electronic transport record].¹⁷⁶

¹⁷³ The original text of this chapter is taken from A/CN.9/WG.III/WP.32, with some drafting improvements suggested to that text. The Working Group has not yet taken a final decision regarding the disposition of this chapter, following its decision in paras. 77-78 of A/CN.9/594 to defer for future discussion the consideration of chapter 12 on transfer of rights.

¹⁷⁴ As set out in footnote 201 of A/CN.9/WG.III/WP.32, there was strong support in the Working Group to maintain the text of draft para. 59(1) as drafted in order to promote harmonization and to accommodate negotiable electronic transport records. The concern raised in para. 132 of A/CN.9/526 regarding nominative negotiable documents under certain national laws was noted.

¹⁷⁵ As set out in footnote 202 of A/CN.9/WG.III/WP.32, para. 2 was discussed during the fifteenth session of the Working Group in conjunction with the other provisions in the draft convention regarding electronic transport records.

¹⁷⁶ As set out in footnote 204 of A/CN.9/WG.III/WP.32, the Working Group requested the Secretariat to prepare a revised draft of para. 2 with due consideration being given to the views expressed. However, the views expressed in the preceding paras. 137 to 139 of A/CN.9/526 were not consistent. Those that favoured a revision of the text requested that the subparagraph stipulate which liabilities the holder that exercised any right under the contract of carriage would assume pursuant to that contract, and an attempt has been made to revise the text. It should be noted that there is a relevant type of liability that ought perhaps to be considered: the liability in respect of loss, damage or injury caused by the goods (but excluding in any event that for breach of the shipper's obligations under draft art. 27).

3. For the purpose of paragraphs 1 and 2 of this article [and article 44],¹⁷⁷ a holder that is not the shipper does not exercise any right under the contract of carriage solely because:

(a) It agrees with the carrier, pursuant to article 10, to replace a negotiable transport document by a negotiable electronic transport record or to replace a negotiable electronic transport record by a negotiable transport document; or

(b) It transfers its rights pursuant to article 59.

Article 61.¹⁷⁸ When no negotiable transport document or negotiable electronic transport record is issued

When no negotiable transport document or no negotiable electronic transport record is issued:

(a) The transfer of rights pursuant to a contract is subject to the law applicable to the contract for the transfer of such rights;

(b) The transfer of rights other than by contract is subject to the law applicable to such other mode of transfer;

(c) The transferability of rights is subject to the law applicable to the contract of carriage; and

(d) Regardless of the law applicable pursuant to subparagraphs (a) and (b) of this article,

(i) A transfer that is otherwise permissible pursuant to the applicable law may be made by electronic means,

(ii) A transfer shall be notified to the carrier by the transferor or, if applicable law permits, by the transferee, and

(iii) The transferor and the transferee are jointly and severally liable for liabilities that are connected to or flow from the right that is transferred.]

CHAPTER 13: LIMITS OF LIABILITY

Article 62. Limits of liability

1. Subject to articles 63 and 64, paragraph 1, the carrier's liability for breaches of its obligations under this Convention¹⁷⁹ is limited to [...] units of account per package or other shipping unit, or [...] units of account per kilogram of the gross weight of the goods that are the subject of the claim or dispute, whichever amount is the higher, except when the value¹⁸⁰ of the goods has been declared by the

¹⁷⁷ Inclusion of the text in square brackets will depend upon the decision of the Working Group regarding the inclusion of the bracketed text in draft art. 44.

¹⁷⁸ Draft art. 61, formerly draft art. 61 bis, has replaced draft arts. 61 and 62 from A/CN.9/WG.III/WP.32, as agreed by the Working Group in para. 213 of A/CN.9/576, following its consideration of the electronic commerce aspects of art. 63, as set out in para. 12 of A/CN.9/WG.III/WP.47, and its consideration of replacing former draft arts. 61 and 62 with draft art. 61 in paras. 212 and 213 of A/CN.9/576.

¹⁷⁹ The addition of breaches of the carrier's obligations is thought to have made the reference to "[or in connection with]" the goods unnecessary.

¹⁸⁰ Further to the decision of the Working Group (paras. 172 and 174, A/CN.9/616), reference to the "nature" of the goods has been deleted.

shipper and included in the contract particulars, or when a higher amount than the amount of limitation of liability set out in this article has been agreed upon between the carrier and the shipper.

Variant A of paragraph 2¹⁸¹

[2. Notwithstanding paragraph 1 of this article, if (a) the carrier cannot establish whether the goods were lost or damaged [or whether the delay in delivery was caused]¹⁸² during the sea carriage or during the carriage preceding or subsequent to the sea carriage and (b) provisions of an international convention [or national law] would be applicable pursuant to article 26 if the loss, damage, [or delay] occurred during the carriage preceding or subsequent to the sea carriage, the carrier's liability for such loss, damage, [or delay] is limited pursuant to the limitation provisions of any international convention [or national law]¹⁸³ that would have applied if the place where the damage occurred had been established, or pursuant to the limitation provisions of this Convention, whichever would result in the higher limitation amount.]

Variant B of paragraph 2

[2. Notwithstanding paragraph 1 of this article, if the carrier cannot establish whether the goods were lost or damaged [or whether the delay in delivery was caused]¹⁸⁴ during the sea carriage or during the carriage preceding or subsequent to the sea carriage, the highest limit of liability in the international [and national]¹⁸⁵ mandatory provisions applicable to the different parts of the transport applies.]

3. When goods are carried in or on a container, pallet, or similar article of transport used to consolidate goods, the packages or shipping units enumerated in the contract particulars as packed in or on such article of transport are deemed packages or shipping units. If not so enumerated, the goods in or on such article of transport are deemed one shipping unit.

4. The unit of account referred to in this article is the Special Drawing Right as defined by the International Monetary Fund. The amounts referred to in this article are to be converted into the national currency of a State according to the value of such currency at the date of judgement or award or the date agreed upon by the parties. The value of a national currency, in terms of the Special Drawing Right, of a Contracting State that is a member of the International Monetary Fund is to be calculated in accordance with the method of valuation applied by the International Monetary Fund in effect at the date in question for its operations and transactions. The value of a national currency, in terms of the Special Drawing Right, of a Contracting State that is not a member of the International Monetary Fund is to be calculated in a manner to be determined by that State.

¹⁸¹ If draft article 62(2) is retained, its text should be adjusted based on the final text of draft article 26. Variant A is intended as a clarification of the text of Variant B, and is not intended to change the suggested approach.

¹⁸² See, *infra*, note 184.

¹⁸³ Text placed in square brackets to mirror the text in art. 26(1), pending a decision by the Working Group.

¹⁸⁴ Draft para. 2 was maintained in square brackets, and reference to delay in delivery was introduced in square brackets, for future discussion.

¹⁸⁵ See *supra*, note 183.

*Article 63. Limits of liability for loss caused by delay*¹⁸⁶

Subject to article 64, paragraph 2, compensation for physical loss of or damage to the goods caused by delay shall be calculated in accordance with article 22 and [, unless otherwise agreed,] liability for economic loss caused by delay is limited to an amount equivalent to [one times] the freight payable on the goods delayed. The total amount payable pursuant to this article and article 62, paragraph 1 may not exceed the limit that would be established pursuant to article 62, paragraph 1 in respect of the total loss of the goods concerned.

Article 64. Loss of the benefit of limitation of liability

1. Neither the carrier nor any of the persons referred to in article 18, paragraph 1, is entitled to the benefit of the limitation of liability as provided in article 62¹⁸⁷, or as provided in the contract of carriage,¹⁸⁸ if the claimant proves that the loss resulting from the breach of the carrier's obligation under this Convention was attributable to a personal act or omission of the person claiming a right to limit done with the intent to cause such loss or recklessly and with knowledge that such loss would probably result.

2. Neither the carrier nor any of the persons mentioned in article 18, paragraph 1, is entitled to the benefit of the limitation of liability as provided in article 63 if the claimant proves that the delay in delivery resulted from a personal act or omission of the person claiming a right to limit done with the intent to cause the loss due to delay or recklessly and with knowledge that such loss would probably result.

CHAPTER 14. TIME FOR SUIT

Article 65. Limitation of actions

1. No judicial or arbitral proceedings in respect of claims or disputes arising from a breach of an obligation under this Convention¹⁸⁹ may be commenced after the expiration of a period of two years.¹⁹⁰

2. The period referred to in paragraph 1 of this article commences on the day on which the carrier has delivered the goods, or, in cases in which no goods have been delivered, or only part of the goods have been delivered,¹⁹¹ on the last¹⁹²

¹⁸⁶ Variant B has been deleted and Variant A has been retained from the text as it appeared in A/CN.9/WG.III/WP.56, as agreed by the Working Group (para. 181, A/CN.9/616).

¹⁸⁷ As discussed at paras. 55 and 62 of A/CN.9/552, the suggestion to add a reference to art. 22 might need to be further discussed in the context of chapter 19.

¹⁸⁸ As agreed by the Working Group (para. 198 and 200, A/CN.9/616), the square brackets around the words "[or as provided in the contract of carriage,]" were deleted and the text retained.

¹⁸⁹ The insertion of the phrase "in respect of claims or disputes arising from a breach of an obligation under this Convention" is intended to provide for the same scope of coverage in this provision as in draft article 62.

¹⁹⁰ In keeping with the decision made by the Working Group (see paras. 127-133, A/CN.9/616), Variant B of the text as it appeared in A/CN.9/WG.III/WP.56 was used as the basis for a revised draft by the Secretariat. The text suggested in this regard is intended to contain the essential elements agreed to by the Working Group, but to rephrase the provision in such a fashion so as to avoid consideration of whether rights or actions have been extinguished or time-barred.

¹⁹¹ As agreed by the Working Group, reference to draft article 11 has been deleted (paras. 136 and 143, A/CN.9/616) and accommodation has been made for cases of partial delivery, as provided for in article 20(2) of the Hamburg Rules (para. 138, A/CN.9/616).

day on which the goods should have been delivered. The day on which the period commences is not included in the period.¹⁹³

3. Notwithstanding the expiration of the period set out in paragraph 1 of this article, one party may rely on its claim as a defence or for the purpose of set-off against a claim asserted by the other party.¹⁹⁴

Article 66. Extension of limitation period

The limitation period provided in article 65 shall not be subject to suspension or interruption,¹⁹⁵ but the person against which a claim is made may at any time during the running of the period extend that period by a declaration to the claimant. This period may be further extended by another declaration or declarations.

Article 67. Action for indemnity

An action for indemnity by a person held liable under this Convention may be instituted after the expiration of the period referred to in article 65 if the indemnity action is instituted within the later of:

(a) The time allowed by the applicable law in the jurisdiction where proceedings are instituted; or

(b) 90 days commencing from the day when the person instituting the action for indemnity has either settled the claim or been served with process in the action against itself¹⁹⁶, whichever is earlier.¹⁹⁷

Article 68. Actions against the person identified as the carrier

An action against the bareboat charterer or the person identified as the carrier pursuant to article 38, paragraph 2,¹⁹⁸ may be instituted after the expiration of the period referred to in article 65 if the action is instituted within the later of:

(a) The time allowed by the applicable law in the jurisdiction where proceedings are instituted; or

¹⁹² The square brackets have been removed from around the word “last” as agreed by the Working Group (paras. 133 and 139).

¹⁹³ As set out in footnote 216 of A/CN.9/WG.III/WP.32, the Working Group requested the Secretariat to retain the text of former draft art. 70, as it appeared in A/CN.9/WG.III/WP.56, with consideration being given to possible alternatives to reflect the views expressed. That text has now been moved into this paragraph, and former draft article 70, as it appeared in A/CN.9/WG.III/WP.56, has been deleted. In addition, the last sentence of this paragraph has been added from article 20(3) of the Hamburg Rules.

¹⁹⁴ In keeping with the Working Group’s decision to allow for set-off of claims as a defence even when the limitation period had expired (paras. 130-131, 133, and 154 A/CN.9/616), the Secretariat has prepared draft paragraph 3, based on article 25(2) of the Convention on the Limitation Period in the International Sale of Goods. Former article 73 of the text as it appeared in A/CN.9/WG.III/WP.56 has been deleted as a consequence of the inclusion of this text.

¹⁹⁵ Reference to suspension or interruption of the limitation period has been included further to the agreement in the Working Group (paras. 132-133, A/CN.9/616).

¹⁹⁶ Further to the decision made by the Working Group (para. 152, A/CN.9/616), Variant B of the text as it appeared in A/CN.9/WG.III/WP.56 has been deleted and the text of Variant A retained.

¹⁹⁷ The phrase “whichever is earlier” has been added for clarification in those situations where service of process has already taken place, and discussions regarding settlement occur later.

¹⁹⁸ Drafting clarifications and corrections made to text in light of the revisions made as a consequence of former draft article 40(3), as it appeared in A/CN.9/WG.III/WP.56, now found in draft article 38(2).

(b) 90 days commencing from the day when the carrier has been identified or the registered owner or bareboat charterer has rebutted the presumption that it is the carrier, pursuant to article 38, paragraph 2.¹⁹⁹

CHAPTER 15. JURISDICTION²⁰⁰

Article 69. Actions against the carrier

Unless the contract of carriage contains an exclusive choice of court agreement that complies with²⁰¹ article 70 or 75, the plaintiff has the right to institute judicial proceedings under this Convention against the carrier:

(a) In a competent court within the jurisdiction of which is situated one of the following places:

- (i) The domicile of the carrier;²⁰²
- (ii) The place of receipt agreed in the contract of carriage;²⁰³
- (iii) The place of delivery agreed in the contract of carriage; or
- (iv) The port where the goods are initially loaded on a ship or the port where the goods are finally discharged from a ship; or

(b) In a competent court or courts designated by an agreement between the shipper and the carrier for the purpose of deciding claims against the carrier that may arise under this Convention.²⁰⁴

Article 70. Choice of court agreements²⁰⁵

1. The jurisdiction of a court chosen in accordance with article 69, paragraph (b), is exclusive for disputes between the parties to the contract only if the parties so agree and the agreement conferring jurisdiction:

(a) Is contained in a volume contract that clearly states the names and addresses of the parties and either (i) is individually negotiated; or (ii) contains a

¹⁹⁹ Consequential drafting changes have been made to this provision as a result of the revised text of former draft article 40(3), as it appeared in A/CN.9/WG.III/WP.56, now found in draft article 38(2).

²⁰⁰ The suggested drafting changes are made to the version of this chapter as it appeared in the annex to A/CN.9/WG.III/WP.75, as considered by the Working Group in paras. 245-266 of A/CN.9/616.

²⁰¹ "Complies with" is suggested as preferable to "is valid", which appeared previously in the text.

²⁰² Reference corrected to "carrier" rather than to "defendant" in order to be consistent with draft article 71 regarding actions against maritime performing parties.

²⁰³ Subparagraphs (ii) and (iii) were placed in separate subparas. from the previous text as it appeared in A/CN.9/WG.III/WP.75 for the purposes of clarity.

²⁰⁴ The text in subparagraph (b) replaces that of both former subparagraph (d) and former draft article 76(1), as they appeared in the text in A/CN.9/WG.III/WP.75, and which have been deleted in this version of the draft convention.

²⁰⁵ The first paragraph of this provision as it appeared in the annex to A/CN.9/WG.III/WP.75 has been deleted and, as a drafting improvement, replaced with a reference to draft article 69(b) in paragraph 1.

prominent statement that there is an exclusive choice of court agreement and specifies the sections of the volume contract containing that agreement;²⁰⁶ and

(b) Clearly²⁰⁷ designates the courts of one Contracting State or one or more specific courts of one Contracting State.

2. A person that is not a party to the volume contract is only bound by an exclusive choice of court agreement concluded in accordance with paragraph 1 of this article if:

(a) The court is in one of the places designated in article 69, paragraph (a);

(b) That agreement is contained in the contract particulars of a transport document or electronic transport record that evidences the contract of carriage for²⁰⁸ the goods in respect of which the claim arises;

(c) That person is given timely and adequate notice of the court where the action shall be brought and that the jurisdiction of that court is exclusive; and

(d) [The law of the court seized²⁰⁹][The law of the [agreed] place of delivery of the goods][The law of the place of receipt of the goods [by the carrier]][The applicable law pursuant to the rules of private international law of the law of the forum]²¹⁰ recognizes that that person may be bound by the exclusive choice of court agreement.

[3. This article does not prevent a Contracting State from giving effect to a choice of court agreement that does not meet the requirements of paragraphs 1 or 2 of this article. Such Contracting State shall give notice to that effect [to _____].²¹¹

4. (a) Nothing in paragraph 3 of this article or in a choice of court agreement effective pursuant to paragraph 3 of this article prevents a court specified in article 69[, paragraph (a)] and situated in a different Contracting State from exercising its jurisdiction over the dispute and deciding the dispute under this Convention.

²⁰⁶ The phrase “sections of” has replaced the phrase “location within” as accurately reflecting the text of draft article 89(1)(b).

²⁰⁷ The phrase “clearly designates the courts of one Contracting State or one or more specific courts of one Contracting State” has been retained and the square brackets deleted in accordance with the decision taken by the Working Group (para. 256, A/CN.9/616). Further, former draft paragraph (c), as it appeared in A/CN.9/WG.III/WP.75 has been deleted as agreed by the Working Group (para. 257, A/CN.9/616).

²⁰⁸ As agreed in the Working Group, the square brackets around draft paragraph (b) have been deleted, and the phrase “that evidences the contract of carriage for” has replaced the phrase “issued in relation to” (para. 258, A/CN.9/616).

²⁰⁹ The Working Group may wish to consider whether further clarification may be necessary to ascertain whether the “court seized” will necessarily be the competent court, or whether it may be another court.

²¹⁰ Various alternatives for this provision have been added as agreed by the Working Group (para. 259, A/CN.9/616).

²¹¹ The Working Group may wish to consider the interplay between this approach and the final clauses.

(b) Except as provided in this chapter, no choice of court agreement is exclusive with respect to an action [against a carrier] under this Convention.^{212]}²¹³

*Article 71. Actions against the maritime performing party*²¹⁴

The plaintiff has the right to institute judicial proceedings under this Convention against the maritime performing party in a competent court within the jurisdiction of which is situated one of the following places:

(a) The domicile of the maritime performing party; or

(b) The port where the goods are initially received by the maritime performing party or the port where the goods are finally delivered by the maritime performing party, or the port in which the maritime performing party performs its activities with respect to the goods.²¹⁵

*Article 72. No additional bases of jurisdiction*²¹⁶

Subject to articles 74 and 75, no judicial proceedings under this Convention against the carrier or a maritime performing party may be instituted in a court not designated pursuant to articles 69, [or] 71 [or pursuant to rules applicable due to the operation of article 77, paragraph 2].²¹⁷

*Article 73. Arrest and provisional or protective measures*²¹⁸

Nothing in this Convention affects jurisdiction with regard to provisional or protective measures, including arrest. A court in a State in which a provisional or protective measure was taken does not have jurisdiction to determine the case upon its merits unless:

(a) The requirements of this chapter are fulfilled; or

(b) An international convention that applies in that State so provides.²¹⁹

²¹² Separate paragraph provided for this provision in order to avoid making it subject to paragraph 3 of this article, as suggested by the Working Group in paragraph 80 of A/CN.9/591.

²¹³ Square brackets have been inserted around draft paragraphs 3 and 4 to indicate the Working Group's agreement that if the decision were made to include a reservation or "opt in" clause regarding the entire chapter on jurisdiction, these paragraphs could be deleted (para. 260, A/CN.9/616).

²¹⁴ Text from sixteenth session of Working Group, paragraph 73 of A/CN.9/591, accepted in substance in paragraph 84. A slight variation has been made to the chapeau for drafting purposes only in order to ensure that the chapeau mirrors that of article 69, and text has been suggested in paragraph (b) to accommodate maritime performing parties that operate in a single port. Further, the Working Group may wish to clarify the relationship between articles 70 and 71.

²¹⁵ The square brackets have been deleted from the text as it appeared in the annex to A/CN.9/WG.III/WP.75, in addition to the deletion of the words "single" and "all of", as agreed by the Working Group (para. 261, A/CN.9/616).

²¹⁶ Text from sixteenth session of Working Group, paragraph 73 of A/CN.9/591, accepted in substance in paragraph 84, with a clarification concerning proceedings against the carrier or a maritime performing party.

²¹⁷ The phrase in square brackets would be necessary if a "partial opt-in" approach to this chapter were adopted pursuant to draft article 77(2).

²¹⁸ Text from sixteenth session of Working Group, paragraph 73 of A/CN.9/591, accepted in substance in paragraph 84.

Article 74. Consolidation and removal of actions

1. Except when there is an exclusive choice of court agreement that is valid pursuant to articles 70 [or] 75 [or pursuant to rules applicable due to the operation of article 77, paragraph 2]²²⁰, if a single action is brought against both the carrier and the maritime performing party arising out of a single occurrence, the action may be instituted only in a court designated pursuant to both article 69 and article 71. If there is no such court, such action may be instituted in a court designated pursuant to article 71, subparagraph (b), if there is such a court.

2. Except when there is an exclusive choice of court agreement that is valid pursuant to articles 70 [or] 75 [or pursuant to rules applicable due to the operation of article 77, paragraph 2]²²¹, a carrier or a maritime performing party that institutes an action seeking a declaration of non-liability or any other action that would deprive a person of its right to select the forum pursuant to article 69 or 71²²² shall at the request of the defendant, withdraw that action once the defendant has chosen a court designated pursuant to article 69 or 71, whichever is applicable, where the action may be recommenced²²³

Article 75. Agreement after dispute has arisen and jurisdiction when the defendant has entered an appearance²²⁴

1. After the dispute has arisen, the parties to the dispute may agree to resolve it in any competent court.

2. A competent²²⁵ court in a Contracting State before which a defendant appears, without contesting jurisdiction in accordance with the rules of that court, has jurisdiction.

²¹⁹ The square brackets in the text have been removed as agreed in the Working Group (para. 262, A/CN.9/616) and the text inside retained, and the phrase “according to its rules of application” has been deleted as redundant.

²²⁰ The phrase in square brackets would be necessary if a “partial opt-in” approach to this chapter were adopted pursuant to draft article 77 (2).

²²¹ The phrase in square brackets would be necessary if a “partial opt-in” approach to this chapter were adopted pursuant to draft article 77 (2).

²²² The text “seeking a declaration of non-liability or any other action that would deprive a person of its right to select the forum under articles 69 or 71” has been inserted and the alternative texts that appeared in A/CN.9/WG.III/WP.75 have been deleted in keeping with the decision of the Working Group (para. 263, A/CN.9/616).

²²³ It is suggested that the closing phrase of the previous text as it appeared in A/CN.9/WG.III/WP.75 “and may recommence it in one of the courts designated under articles 69 or 71, whichever is applicable, as chosen by the defendant” be replaced with the phrase “once the defendant has chosen a court designated pursuant to article 69 or 71, whichever is applicable, where the action may be recommenced” in order to make clear that the defendant is required to choose a court in which the case should be heard, and cannot simply avoid the action by failing to choose a court.

²²⁴ Text from sixteenth session of Working Group, paragraph 73 of A/CN.9/591, accepted in substance in paragraph 84. The opening phrase “Notwithstanding the preceding articles of this chapter” has been deleted as redundant, as references to article 75 have been added to articles 69, 70 and 74, and opening phrase of the second paragraph has been clarified from “a competent court” to “a court in a Contracting State”.

²²⁵ The word “competent” has been inserted as agreed in the Working Group (para. 264, A/CN.9/616).

*Article 76. Recognition and enforcement*²²⁶

1. A decision made by a court having jurisdiction under this Convention shall be recognized and enforced in another Contracting State in accordance with the law of that Contracting State when both States have made a declaration in accordance with article 77.

2. A court may refuse recognition and enforcement:

(a) Based on the grounds for the refusal of recognition and enforcement available pursuant to its law;

(b) If the action in which the decision was rendered would have been subject to withdrawal pursuant to article 74, paragraph 2, had the court that rendered the decision applied the rules on exclusive choice of court agreements of the State in which recognition and enforcement is sought; or

(c) If a court of that Contracting State had exclusive jurisdiction in a dispute resulting in the decision in respect of which recognition and enforcement is sought pursuant to the rules applied as a result of a declaration made pursuant to article 77, paragraph 2.

3. This chapter shall not affect the application of the rules of a regional economic integration organization that is a party to this Convention, as concerns the recognition or enforcement of judgments as between member states of the regional economic integration organization, whether adopted before or after this Convention.

*Article 77. Application of chapter 15*²²⁷[Variant A]

A Contracting State may declare at the time of signature, ratification, acceptance, approval or accession, in accordance with article 94, that it will not be bound by the provisions of this chapter.]

[Variant B]

The provisions of this chapter shall bind only Contracting States that declare [at the time of signature, ratification, acceptance, approval or accession,] [at any time thereafter] in accordance with article 94, that they will be bound by them.]

[Variant C] would consist of Variant B plus the following text as a second para.:

A Contracting State that makes a declaration pursuant to paragraph 1 of this article may at the same time declare that it will not be bound by article 70 and its courts shall instead apply the rules which would be otherwise applicable in that Contracting State.]

²²⁶ The suggested drafting changes are made to the version of this draft article as it appeared in the annex to A/CN.9/WG.III/WP.75, in order to accommodate the possible adoption by the Working Group of a whole or partial reservation or “opt in” approaches with respect to chapter 15, in keeping with paras. 265-266 of A/CN.9/616.

²²⁷ Variant A is intended to represent the reservation approach to the chapter on jurisdiction, while Variant B is intended to represent the “opt-in” approach, and Variant C, which would consist of both Variants B and C, is intended to represent a “partial opt-in” approach (see A/CN.9/616, paras. 246-252).

CHAPTER 16. ARBITRATION²²⁸*Article 78. Arbitration agreements*

1. Subject to this chapter, parties may agree that any dispute that may arise relating to the carriage of goods under this Convention shall be referred to arbitration.

2. The arbitration proceedings shall, at the option of the person asserting a claim against the carrier, take place at²²⁹:

(a) Any place designated for that purpose in the arbitration agreement; or

(b) Any other place situated in a State where any of the places specified in article 69, subparagraph (a), is located.

3. The designation of the place of arbitration in the agreement is binding for disputes between the parties to the agreement if it is contained in a volume contract that clearly states the names and addresses of the parties and either

(a) Is individually negotiated; or

(b) Contains a prominent statement that there is an arbitration agreement and specifies the sections of²³⁰ the volume contract containing the arbitration²³¹ agreement.

4. When an arbitration agreement has been concluded in accordance with paragraph 3 of this article, a person that is not a party to the volume contract is bound by the designation of the place of arbitration in that agreement only if:

(a) The place of arbitration designated in the agreement is situated in one of the places referred to in article 69, subparagraph (a);

[(b) The agreement is contained in the contract particulars of a transport document or electronic transport record that evidences the contract of carriage for the goods in respect of which the claim arises;]

(c) The person to be bound is given timely and adequate notice of the place of arbitration; and

(d) Applicable law²³² permits that person to be bound by the arbitration agreement.

5. The provisions of paragraphs 1, 2, 3, and 4 of this article are deemed to be part of every arbitration clause or agreement, and any term of such clause or agreement to the extent that it is inconsistent therewith is void.

²²⁸ The suggested changes to the text of this chapter are to the version of the provision as it appeared in para. 270 of A/CN.9/616.

²²⁹ The phrase “one of the following locations” has been deleted as redundant.

²³⁰ The phrase “sections of” has replaced the phrase “location within” as accurately reflecting the text of draft article 89(1)(b).

²³¹ The phrase “containing the arbitration” has replaced “of that” for greater precision.

²³² It is suggested that the phrase “[for the arbitration agreement]” be deleted as it has caused confusion regarding the applicable law in the past.

*Article 79. Arbitration agreement in non-liner transportation*²³³

1. Nothing in this Convention affects the enforceability of an arbitration agreement in a contract of carriage in non-liner transportation to which this Convention or the provisions of this Convention apply by reason of:

- (a) The application of article 7; or
- (b) The parties' voluntary incorporation of this Convention in a contract of carriage that would not otherwise be subject to this Convention.

2. Notwithstanding paragraph 1 of this article, an arbitration agreement in a transport document or electronic transport record to which this Convention applies by reason of the application of article 7 is subject to this Chapter unless:

(a) The terms of such arbitration agreement are the same as the terms of the arbitration agreement in the charterparty or other contract of carriage excluded from the application of this Convention by reason of the application of article 7; or

(b) Such an arbitration agreement: (i) incorporates by reference the terms of the arbitration agreement contained in the charterparty or other contract of carriage excluded from the application of this Convention by reason of the application of article 7; (ii) specifically refers to the arbitration clause; and (iii) identifies the parties to and the date of the charterparty.

Article 80. Agreements for arbitration after the dispute has arisen

Notwithstanding the provisions of this chapter and chapter 15, after a dispute has arisen, the parties to the dispute may agree to resolve it by arbitration in any place.

*Article 81. Application of chapter 16*²³⁴[Variant A]

A Contracting State may declare at the time of signature, ratification, acceptance, approval or accession, in accordance with article 94, that it will not be bound by the provisions of this chapter.]

[Variant B]

The provisions of this chapter shall be binding only on Contracting States that declare [at the time of signature, ratification, acceptance, approval or accession,] [at any time thereafter] in accordance with article 94, that they will be bound by them.]

²³³ In response to the views of the Working Group as set out in paras. 276-277 of A/CN.9/616 and in order to clarify this provision in general, this draft article has been substantially adjusted from the version set out in para. 270 of A/CN.9/616.

²³⁴ For the purposes of consistency, the drafting approach taken in both Variants A and B is similar to that taken in draft article 77, with respect to the chapter on jurisdiction. Variant A is intended to represent the reservation approach to the chapter on arbitration, while Variant B is intended to represent the "opt-in" approach. A "partial opt-in" approach was considered with respect to the chapter on arbitration, as suggested in discussion in the Working Group (see A/CN.9/616, paras. 278-279), but was not considered necessary or practicable with respect to arbitration.

CHAPTER 17. GENERAL AVERAGE

Article 82. Provisions on general average

Nothing in this Convention prevents the application of terms in the contract of carriage or provisions pursuant to national law regarding the adjustment of general average.

CHAPTER 18. OTHER CONVENTIONS

*Article 83. Denunciation of other conventions*²³⁵

1. A State that ratifies, accepts, approves or accedes to this Convention and is a party to the International Convention for the Unification of certain Rules relating to Bills of Lading signed at Brussels on 25 August 1924; to the Protocol signed on 23 February 1968 to amend the International Convention for the Unification of certain Rules relating to Bills of Lading signed at Brussels on 25 August 1924; or to the Protocol to amend the International Convention for the Unification of certain Rules relating to Bills of Lading as Modified by the Amending Protocol of 23 February 1968, signed at Brussels on 21 December 1979, shall at the same time denounce that Convention and the protocol or protocols thereto to which it is a party by notifying the Government of Belgium to that effect.

2. A State that ratifies, accepts, approves or accedes to this Convention and is a party to the United Nations Convention on the Carriage of Goods by Sea concluded at Hamburg on 31 March 1978, shall at the same time denounce that Convention by notifying the Secretary-General of the United Nations to that effect.

3. For the purpose of this article, ratifications, acceptances, approvals and accessions in respect of this Convention by States parties to the instruments listed in paragraphs 1 and 2 of this article are not effective until such denunciations as may be required on the part of those States in respect of these instruments have themselves become effective. The depositary of this Convention shall consult with the Government of Belgium, as the depositary of the instruments referred to in paragraph 1 of this article, so as to ensure necessary co-ordination in this respect.²³⁶

Article 84. International conventions governing the carriage of goods by air

Nothing in this Convention prevents a Contracting State from applying the provisions of any other international convention regarding the carriage of goods by air to the contract of carriage when such international convention according to its provisions applies to any part of the contract of carriage.²³⁷

²³⁵ Draft article 83 consists of former article 102 as it appeared in A/CN.9/WG.III/WP.56, which has been moved to this location from its previous location in the chapter on Final Clauses. It is thought that chapter 18 on Other Conventions reads more logically with the addition of former article 102, now draft article 83, on denunciations to this location.

²³⁶ Text based on paras. 99(3) and (6) of the United Nations Convention on Contracts for the International Sale of Goods. See also art. 31 of the Hamburg Rules.

²³⁷ Suggested approach along the lines of former draft article 89 as it appeared in A/CN.9/WG.III/WP.56 to ensure that there is no conflict of conventions with the Montreal Convention, as considered by the Working Group in paras. 225 and 234-235 of A/CN.9/616.

Article 85. Global limitation of liability

This Convention does not modify the rights or obligations of the carrier, or the performing party provided for in international conventions or national law applicable to the limitation of liability of owners of seagoing ships or the limitation of liability for maritime claims.²³⁸

Article 86. Other provisions on carriage of passengers and luggage

No liability arises under this Convention for any loss of or damage to or delay in delivery of luggage for which the carrier is liable under any convention or national law applicable to the carriage of passengers and their luggage.

Article 87. Other provisions on damage caused by nuclear incident

No liability arises under this Convention for damage caused by a nuclear incident if the operator of a nuclear installation is liable for such damage:

(a) Under the Paris Convention on Third Party Liability in the Field of Nuclear Energy of 29 July 1960 as amended by the additional Protocol of 28 January 1964, the Vienna Convention on Civil Liability for Nuclear Damage of 21 May 1963 as amended by the Joint Protocol Relating to the Application of the Vienna Convention and the Paris Convention of 21 September 1988, and as amended by the Protocol to Amend the 1963 Vienna Convention on Civil Liability for Nuclear Damage of 12 September 1997, or the Convention on Supplementary Compensation for Nuclear Damage of 12 September 1997, including any amendment to these conventions and any future convention in respect of the liability of the operator of a nuclear installation for damage caused by a nuclear incident; or

(b) By virtue of national law applicable to the liability for such damage, provided that such law is in all respects as favourable to persons that may suffer damage as either the Paris or Vienna Conventions or the Convention on Supplementary Compensation for Nuclear Damage.

CHAPTER 19. VALIDITY OF CONTRACTUAL TERMS²³⁹*Article 88. General provisions*²⁴⁰

1. Unless otherwise provided in this Convention, any term in a contract of carriage is void to the extent that it:

(a) Directly or indirectly excludes or limits the obligations of the carrier or a maritime performing party under this Convention;

(b) Directly or indirectly excludes or limits the liability of the carrier or a maritime performing party for breach of an obligation under this Convention; or

²³⁸ The phrase “for maritime claims” has been added in order to reflect the terminology of the Convention on Limitation of Liability for Maritime Claims, 1976 and its 1996 Protocol.

²³⁹ The Working Group may wish to consider whether this chapter would be better placed before chapter 17 on general average, or merged into chapter 2 on scope of application.

²⁴⁰ Revised draft based on text in A/CN.9/WG.III/WP.61, para. 46, as requested by the Working Group (A/CN.9/594, paras. 147 and 153). The word “provision” has been substituted for “stipulation”.

(c) Assigns a benefit of insurance of the goods in favour of the carrier or a person referred to in article 18, paragraph 1.

[2. Unless otherwise provided in this Convention, any term in a contract of carriage is void to the extent that it:

(a) Directly or indirectly excludes, limits, [or increases] the obligations under this Convention of the shipper, consignor, consignee, controlling party, holder, or documentary shipper; or

(b) Directly or indirectly excludes, limits, [or increases] the liability of the shipper, consignor, consignee, controlling party, holder, or documentary shipper for breach of any of its obligations under this Convention.]

Article 89. Special rules for volume contracts ²⁴¹

1. Notwithstanding article 88, as between the carrier and the shipper,²⁴² a volume contract to which this Convention applies may provide for greater or lesser rights, obligations, and liabilities than those set forth in this Convention provided that the volume contract contains a prominent statement that it derogates from this Convention, and:

(a) Is individually negotiated; or

(b) Prominently specifies the sections of the volume contract containing the derogations.

2. A derogation pursuant to paragraph 1 of this article shall be set forth in the volume contract and may not be incorporated by reference from another document.

3. A carrier's public schedule of prices and services, transport document, electronic transport record, or similar document is not a volume contract pursuant to paragraph 1 of this article, but a volume contract may incorporate such documents by reference as terms of the contract.

4. Paragraph 1 of this article does not apply to rights and obligations provided in articles 16, subparagraphs (1)(a) and (b), 29 and 32 or to liability arising from the breach thereof, nor does paragraph 1 of this article apply to any liability arising from an act or omission referred to in article 64.²⁴³

5. The terms of the volume contract that derogate from this Convention, if the volume contract satisfies the requirements of paragraph 1 of this article, apply between the carrier and any person other than the shipper provided that:

²⁴¹ Revised draft based on alternative version in A/CN.9/WG.III/WP.61, para. 49, with amendments to paras. 4 and 5 requested by the Working Group (A/CN.9/594, paras. 163-167). Drafting adjustments have been made to the text of para. 5 with the intention of improving clarity but not changing the substance, and former subpara. 5(c) as it appeared in para. 49 of A/CN.9/WG.III/WP.61 has been moved into a separate para. 6.

²⁴² The phrase "as between the carrier and the shipper" has been added to this paragraph to accommodate the simplified version of para. 5 now inserted into the draft convention by ensuring the inclusion of the text in former subpara. 5(a) of the draft article as set out in para. 49 of A/CN.9/WG.III/WP.61, which stated "Paragraph 1 of this article applies between the carrier and the shipper".

²⁴³ Revised draft based on text in A/CN.9/WG.III/WP.61, para. 49, with amendments regarding the reference to draft art. 64 as requested by the Working Group (A/CN.9/594, paras. 158-162).

(a) Such person received information that prominently states that the volume contract derogates from this Convention and gives its express consent to be bound by such derogations; and

(b) Such consent is not solely set forth in a carrier's public schedule of prices and services, transport document, or electronic transport record.²⁴⁴

6. The party claiming the benefit of the derogation bears the burden of proof that the conditions for derogation have been fulfilled.

*Article 90. Special rules for live animals and certain other goods*²⁴⁵

Notwithstanding article 88 and without prejudice to²⁴⁶ article 89, the contract of carriage may exclude or limit the obligations or the liability of both the carrier and a maritime performing party if:

(a) The goods are live animals except when the claimant proves that the loss of or damage to the goods, or delay in delivery resulted from an act or omission of the carrier or of a person referred to in article 18, paragraph 1, or of a maritime performing party done recklessly and with knowledge that such loss or damage,²⁴⁷ or that the loss due to delay, would probably result; or

(b) The character or condition of the goods or the circumstances and terms and conditions under which the carriage is to be performed are such as reasonably to justify a special agreement, provided that such contract of carriage is not related to ordinary commercial shipments made in the ordinary course of trade and no negotiable transport document or negotiable electronic transport record is issued for the carriage of the goods.

CHAPTER 20. FINAL CLAUSES

Article 91. Depositary

The Secretary-General of the United Nations is hereby designated as the depositary of this Convention.²⁴⁸

Article 92. Signature, ratification, acceptance, approval or accession

1. This Convention is open for signature by all States [at [...] from [...] to [...] and thereafter] at the Headquarters of the United Nations in New York from [...] to [...].

²⁴⁴ Drafting adjustments have been made to the text of para. 5 as set out in para. 49 of A/CN.9/WG.III/WP.61 with the intention of improving clarity but not changing the substance. Former subpara. 5(c) as it appeared in para. 49 of A/CN.9/WG.III/WP.61 has been moved into a separate para. 6.

²⁴⁵ Revised draft based on text in A/CN.9/WG.III/WP.61, para. 62, as requested by the Working Group (A/CN.9/594, paras. 163-167).

²⁴⁶ In the opening phrase of para (a), the phrase "without prejudice to" has been added to the text as set out in para. 62 of A/CN.9/WG.III/WP.61 to better reflect the nature of articles 88 and 89.

²⁴⁷ In order to avoid repetition, the phrase "would probably occur or recklessly and with knowledge" has been deleted from the text as set out in para. 62 of A/CN.9/WG.III/WP.61.

²⁴⁸ Text taken from art. 15 of the Electronic Contracting Convention and art. 27 of the Hamburg Rules.

2. This Convention is subject to ratification, acceptance or approval by the signatory States.

3. This Convention is open for accession by all States that are not signatory States as from the date it is open for signature.

4. Instruments of ratification, acceptance, approval and accession are to be deposited with the Secretary-General of the United Nations.²⁴⁹

Article 93. Reservations

No reservations are permitted except those expressly authorized in this Convention.²⁵⁰

Article 94. Procedure and effect of declarations²⁵¹

1. Declarations made at the time of signature are subject to confirmation upon ratification, acceptance or approval.

2. Declarations and their confirmations are to be in writing and to be formally notified to the depositary.

3. A declaration takes effect simultaneously with the entry into force of this Convention in respect of the State concerned. However, a declaration of which the depositary receives formal notification after such entry into force takes effect on the first day of the month following the expiration of six months after the date of its receipt by the depositary.

4. Any State that makes a declaration under this Convention may modify or withdraw it at any time by a formal notification in writing addressed to the depositary. The modification or withdrawal is to take effect on the first day of the month following the expiration of six months after the date of the receipt of the notification by the depositary.

Article 95. Effect in domestic territorial units

1. If a Contracting State has two or more territorial units in which different systems of law are applicable in relation to the matters dealt with in this Convention, it may, at the time of signature, ratification, acceptance, approval or accession, declare that this Convention is to extend to all its territorial units or only to one or more of them, and may amend its declaration by submitting another declaration at any time.

2. These declarations are to be notified to the depositary and are to state expressly the territorial units to which the Convention extends.

3. If, by virtue of a declaration pursuant to this article, this Convention extends to one or more but not all of the territorial units of a Contracting State, and if the place of business of a party is located in that State, this place of business, for the purposes of this Convention, is considered not to be in a Contracting State, unless it is in a territorial unit to which the Convention extends.

²⁴⁹ Text taken from art. 16 of the Electronic Contracting Convention.

²⁵⁰ Revised text to accommodate the possible inclusion of reservations regarding chapters 15 and 16.

²⁵¹ Suggested text to accommodate the possible inclusion of reservations regarding chapters 15 and 16.

4. If a Contracting State makes no declaration pursuant to paragraph 1 of this article, the Convention is to extend to all territorial units of that State.²⁵²

*Article 96. Participation by regional economic integration organizations*²⁵³

1. A regional economic integration organization that is constituted by sovereign States and has competence over certain matters governed by this Convention may similarly sign, ratify, accept, approve or accede to this Convention. The regional economic integration organization shall in that case have the rights and obligations of a Contracting State, to the extent that that organization has competence over matters governed by this Convention. When the number of Contracting States is relevant in this Convention, the regional economic integration organization does not count as a Contracting State in addition to its member States which are Contracting States.

2. The regional economic integration organization shall, at the time of signature, ratification, acceptance, approval or accession, make a declaration to the depositary specifying the matters governed by this Convention in respect of which competence has been transferred to that organization by its member States. The regional economic integration organization shall promptly notify the depositary of any changes to the distribution of competence, including new transfers of competence, specified in the declaration pursuant to this paragraph.

3. Any reference to a “Contracting State” or “Contracting States” in this Convention applies equally to a regional economic integration organization when the context so requires.

Article 97. Entry into force

1. This Convention enters into force on the first day of the month following the expiration of [one year] [six months] after the date of deposit of the [twentieth] [third] instrument of ratification, acceptance, approval or accession.

2. For each State that becomes a Contracting State to this Convention after the date of the deposit of the [twentieth] [third] instrument of ratification, acceptance, approval or accession, this Convention enters into force on the first day of the month following the expiration of [one year] [six months] after the deposit of the appropriate instrument on behalf of that State.

3. Each Contracting State shall apply this Convention to contracts of carriage concluded on or after the date of the entry into force of this Convention in respect of that State.²⁵⁴

²⁵² Text is taken from art. 18 of the Electronic Contracting Convention. See also art. 52 of the Convention on International Interests in Mobile Equipment, Cape Town, 16 November 2001.

²⁵³ Text from sixteenth session of Working Group, para. 73 of A/CN.9/591, where it was not discussed, as noted in para. 83 of A/CN.9/591.

²⁵⁴ Text is taken from art. 30 of the Hamburg Rules. Note that the second suggested time period in square brackets is drawn from art. 23 of the Electronic Contracting Convention. The time selected for entry into force, which is a function of both the number of ratifications required and of the length of time required after the deposit of the appropriate instrument, is generally the time considered appropriate for business practice to adjust to the new regime.

Article 98. Revision and amendment

1. At the request of not less than one third of the Contracting States to this Convention, the depositary shall convene a conference of the Contracting States for revising or amending it.

2. Any instrument of ratification, acceptance, approval or accession deposited after the entry into force of an amendment to this Convention is deemed to apply to the Convention as amended.²⁵⁵

Article 99. Amendment of limitation amounts²⁵⁶

1. The special procedure in this article applies solely for the purposes of amending the limitation amount set out in article 62, paragraph 1 of this Convention.

2. Upon the request of at least [one fourth²⁵⁷] of the Contracting States to this Convention,²⁵⁸ the depositary shall circulate any proposal to amend the limitation amount specified in article 62, paragraph 1, of this Convention to all the Contracting States²⁵⁹ and shall convene a meeting of a committee composed of a representative from each Contracting State to consider the proposed amendment.

3. The meeting of the committee shall take place on the occasion and at the location of the next session of the United Nations Commission on International Trade Law.

²⁵⁵ Text is taken from art. 32 of the Hamburg Rules. Amendment procedures are not common in UNCITRAL texts, but the Hamburg Rules have a general provision in art. 32 and a special provision in art. 33 for revision of the limitation amounts and the unit of account. In the Electronic Contracting Convention, the Commission decided not to have a provision on amendments because the States parties to that Convention may initiate an amendment procedure under general treaty law (typically, with a diplomatic conference and an amending protocol, such as in the case of the Convention on the Limitation Period in the International Sale of Goods, as amended by the Protocol of 11 April 1980, New York, 14 June 1974), if applicable, after discussion in the Commission. Note that the amendment provisions at draft arts. 103 and at draft art. 104 may be adopted independently.

²⁵⁶ Text as set out in para. 7 of A/CN.9/WG.III/WP.39, including footnotes. The proposal is based upon the amendment procedure set out at art. 23 of the 2002 Protocol to the Athens Convention ("Athens Convention") and at art. 24 of the United Nations Convention on the Liability of Operators of Transport Terminals in International Trade ("OTT Convention"). Similar approaches have been taken in a number of International Maritime Organization ("IMO") conventions, such as the Protocol of 1992 to amend the International Convention on Civil Liability for Oil Pollution Damage, 1969; the Protocol of 1992 to amend the International Convention on the Establishment of an International Fund for Compensation for Oil Pollution Damage, 1971; the Protocol of 2003 to the International Convention on the Establishment of an International Fund for Compensation for Oil Pollution Damage, 1992 (not yet in force) ("2003 Protocol to the IOPC Fund 1992"); the Protocol of 1996 to amend the Convention on Limitation of Liability for Maritime Claims, 1976; and the International Convention on Liability and Compensation for Damage in connection with the Carriage of Hazardous and Noxious Substances by Sea, 1996.

²⁵⁷ Para. 23(2) of the Athens Convention refers to "one half" rather than "one quarter" of the Contracting States.

²⁵⁸ Para. 23(2) of the Athens Convention includes the phrase "but in no case less than six" of the Contracting States.

²⁵⁹ Para. 23(2) of the Athens Convention also includes reference to Members of the IMO.

4. Amendments shall be adopted by the committee by a two-thirds majority of its members present and voting.²⁶⁰

5. When acting on a proposal to amend the limits, the committee will take into account the experience of claims made under this Convention and, in particular, the amount of damage resulting therefrom, changes in the monetary values and the effect of the proposed amendment on the cost of insurance.²⁶¹

6. (a) No amendment of the limit pursuant to this article may be considered less than [five]²⁶² years from the date on which this Convention was opened for signature or less than [five] years from the date of entry into force of a previous amendment pursuant to this article.

(b) No limit may be increased so as to exceed an amount that corresponds to the limit laid down in this Convention increased by [six] per cent per year calculated on a compound basis from the date on which this Convention was opened for signature.²⁶³

(c) No limit may be increased so as to exceed an amount that corresponds to the limit laid down in this Convention multiplied by [three].²⁶⁴

7. Any amendment adopted in accordance with paragraph 4 of this article shall be notified by the depositary to all Contracting States. The amendment is deemed to have been accepted at the end of a period of [eighteen]²⁶⁵ months after the date of notification, unless within that period not less than [one fourth]²⁶⁶ of the States that were Contracting States at the time of the adoption of the amendment have communicated to the depositary that they do not accept the amendment, in which case the amendment is rejected and has no effect.

8. An amendment deemed to have been accepted in accordance with paragraph 7 of this article enters into force [eighteen]²⁶⁷ months after its acceptance.

²⁶⁰ Para. 23(5) of the Athens Convention is as follows: "Amendments shall be adopted by a two-thirds majority of the Contracting States to the Convention as revised by this Protocol present and voting in the Legal Committee ... on condition that at least one half of the Contracting States to the Convention as revised by this Protocol shall be present at the time of voting."

²⁶¹ This provision has been taken from para. 23(6) of the Athens Convention. See, also, para. 24(4) of the OTT Convention.

²⁶² Paras. 11 and 12 of A/CN.9/WG.III/WP.34 suggest that the time period in this draft paragraph should be seven years rather than five years.

²⁶³ No similar provision is found in the OTT Convention. An alternative approach as suggested in paras. 11 and 12 of A/CN.9/WG.III/WP.34 could be: "No limit may be increased or decreased so as to exceed an amount which corresponds to the limit laid down in this Convention increased or decreased by twenty-one per cent in any single adjustment."

²⁶⁴ No similar provision is found in the OTT Convention. An alternative approach as suggested in paras. 11 and 12 of A/CN.9/WG.III/WP.34 could be: "No limit may be increased or decreased so as to exceed an amount which in total exceeds the limit laid down in this Convention by more than one hundred per cent, cumulatively."

²⁶⁵ Paras. 11 and 12 of A/CN.9/WG.III/WP.34 suggest that the time period in draft paras. 7, 8 and 10 should be twelve months rather than eighteen months.

²⁶⁶ The OTT Convention specifies at para. 24(7) "not less than one third of the States that were States Parties".

²⁶⁷ Recent IMO conventions have reduced this period to twelve months when urgency is important. See, for example, the 2003 Protocol to the IOPC Fund 1992, at para. 24(8).

9. All Contracting States are bound by the amendment unless they denounce this Convention in accordance with article 100 at least six months before the amendment enters into force. Such denunciation takes effect when the amendment enters into force.

10. When an amendment has been adopted but the [eighteen]-month period for its acceptance has not yet expired, a State that becomes a Contracting State during that period is bound by the amendment if it enters into force. A State that becomes a Contracting State after that period is bound by an amendment that has been accepted in accordance with paragraph 7 of this article. In the cases referred to in this paragraph, a State becomes bound by an amendment when that amendment enters into force, or when this Convention enters into force for that State, if later.

Article 100. Denunciation of this Convention

1. A Contracting State may denounce this Convention at any time by means of a notification in writing addressed to the depositary.

2. The denunciation takes effect on the first day of the month following the expiration of one year after the notification is received by the depositary. If a longer period is specified in the notification, the denunciation takes effect upon the expiration of such longer period after the notification is received by the depositary.²⁶⁸

DONE at [...], this [...] day of [...], [...], in a single original, of which the Arabic, Chinese, English, French, Russian and Spanish texts are equally authentic.

IN WITNESS WHEREOF the undersigned plenipotentiaries, being duly authorized by their respective Governments, have signed this Convention.

²⁶⁸ Text is taken from art. 34 of the Hamburg Rules. The second sentence of para. 2 is not strictly necessary but is present in the Hamburg Rules and in some other UNCITRAL treaties, including the Electronic Contracting Convention. It is not present, for instance, in art. 27 of the United Nations International Convention for the Suppression of Acts of Nuclear Terrorism, 2005 (the most recent text deposited with the Secretary-General), which provides some slightly modified alternative language:

“1. Any State Party may denounce this Convention by written notification to the Secretary-General of the United Nations.
2. Denunciation shall take effect one year following the date on which notification is received by the Secretary-General of the United Nations.”

**L. Note by the Secretariat on the preparation of a draft convention
on the carriage of goods [wholly or partly] [by sea] — Position of the
French National Committee of the International Chamber of
Commerce (ICC France), submitted to the Working Group on
Transport Law at its nineteenth session
(A/CN.9/WG.III/WP.82) [Original: French]**

In preparation for the nineteenth session of Working Group III (Transport Law), the French National Committee of the International Chamber of Commerce (ICC France) submitted to the Secretariat the document attached hereto as an annex containing its comments and proposals on provisions of the draft convention on the carriage of goods [wholly or partly] [by sea] scheduled for discussion during the session.

The document in the attached annex is reproduced in the form in which it was received by the Secretariat.

ANNEX

**Position of ICC France submitted to UNCITRAL Working
Group III (Transport Law)**

Draft convention on the carriage of goods [wholly or partly] [by sea]

Provisions relating to arbitration

1. At its sixteenth session (Vienna, 28 November-9 December 2005), Working Group III (Transport Law), having been entrusted with preparing a draft convention on the carriage of goods [wholly or partly] [by sea], considered document A/CN.9/WG.III/WP.54, which contains a proposal by the Netherlands on arbitration.

That document was presented as a compromise between the principle of unqualified freedom to arbitrate and the view that arbitration should be available to the parties to a dispute but should not be capable of being used by parties in order to circumvent the bases of jurisdiction set out in draft article 75 of the draft convention.

The compromise proposed by the Netherlands entails the deletion of the entire chapter on arbitration and the addition of a paragraph 2 to draft article 78 of the draft convention with the intention of ensuring that the rules in the draft convention on jurisdiction could not be circumvented.

This compromise also entails the inclusion of a reference in draft article 81 to make effective any agreement made by the parties to refer a dispute that has arisen between them to arbitration.

The aim of the proposal is to preserve the status quo with respect to the use of arbitration in the maritime transport industry by providing minimal arbitration rules

with respect to the liner industry while maintaining freedom of arbitration in the non-liner industry through the addition of draft article 81 bis.

2. The report of Working Group III (A/CN.9/591) on the work of its sixteenth session (Vienna, 28 November-9 December 2005) stated that the compromise proposal of the Netherlands had given rise to reservations on the part of several delegations.

The report recalled that the question had been raised as to whether the compromise proposal of the Netherlands (A/CN.9/WG.III/WP.54) might limit the use of arbitration in the liner trade.

It was stressed that commercial enterprises would in fact be unlikely to include arbitration provisions in a contract unless they could with certainty determine the place of arbitration.

However, given the current wording of draft article 75, the determination of the place of arbitration might not be possible.

The report also pointed out that refinements were called for in the drafting of the proposed text, in particular in view of the new provisions considered for the jurisdiction chapter.

3. The comments by the delegation of ICC France on the work of Working Group III at its sixteenth session (Vienna, 28 November-9 December 2005) indicated that the French delegation had reservations concerning the Netherlands proposal.

The French delegation recalled that, although during the discussions it had accepted the principle of the compromise, it did not agree with the wording of the text subsequently drawn up, which did not reflect the discussions.

The French delegation had also pointed out that the wording of article 83 raised a number of difficulties, in particular by granting the claimant the option of instituting court proceedings or resorting to arbitration.

Several delegations (France, the United Kingdom, Italy and the Baltic and International Maritime Council (BIMCO)), supported by the delegation of ICC France, stressed that they disagreed with the wording of article 83, which conflicted with arbitration practice.

In the light of those difficulties, the secretariat of the Working Group was asked to give its opinion.

The secretariat pointed out that the solutions recommended in document A/CN.9/WG.III/WP.54 were unusual and it suggested that the wording of article 83 should be re-examined.

4. In that context, ICC France wishes to comment on those provisions of the draft convention that deal with arbitration.

4.1. *Draft article 76: choice of court agreements*

4.1.1. Draft article 76 (1) stipulates that the choice of court agreement has to be concluded or documented in writing.

Arbitration agreements appear to be covered by this definition.

However, they may not be entered into orally or implicitly.

4.1.2. Draft article 76 (2) stipulates that an arbitration agreement (i) has to be included in a volume contract with a clear indication of the parties and (ii) must clearly state the name and location of the chosen court.

(i) As regards volume contracts, it would be desirable to broaden the scope of admission of arbitration agreements to all contracts of carriage of goods by sea.

(ii) As regards the statement of the name and location of the court, such a requirement seems incompatible with an arbitration clause.

It also weakens the role of arbitration institutions, which have no opportunity to remedy any disagreement of the parties concerning the place of arbitration and the designation of arbitrators.

4.1.3. Draft article 76 (3) stipulates that an exclusive choice of court clause is binding on a person that is not a party to the volume contract provided that this is consistent with applicable law as determined by international private law or the conflict of law rules of the court seized.

Recourse to conflict rules may be seen to be obsolete in international trade.

This provision also applies to courts.

Under these circumstances, it would be appropriate to allow an option for arbitration, with the exclusion of the courts.

4.2. *Draft article 81 bis: recognition and enforcement*

This article relates only to decisions made “by a court of one Contracting State” (*“par un tribunal d’un État contractant”*).

However, an arbitral tribunal, by its nature, is not under the jurisdiction of a State.

The provisions concerning recognition and enforcement of decisions will therefore not be applicable to arbitration.

It should, however, be recalled that the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards remains applicable.

The formulation “*par un tribunal siégeant dans un État contractant*” would appear to be preferable.

4.3. *Draft article 83: arbitration agreements*

This article provides that (i) the arbitration agreement has to specify the place of arbitration and (ii) the claimant may, even where there is an arbitration agreement, institute judicial proceedings in any place specified in draft article 75 of the convention.

The option available to the claimant of instituting judicial proceedings seems to conflict with international arbitration practice, in particular where contrary to the principle of jurisdiction to decide jurisdiction.

5. At the eighteenth session of Working Group III (Vienna, 6 November-17 November 2006), the Secretariat presented a document on arbitration (A/CN.9/WG.III/XVIII/CRP.3) prepared in conjunction with Working Group II in line with the New York Convention.

The statement by the delegation of ICC France indicated that the new wording of chapter 17 on arbitration was intended to prevent the provisions of chapter 16 on jurisdiction being circumvented.

The French delegation approved chapter 17 as a whole.

However, it did not wish to adopt a position on article 85 bis (applicability of chapter 17 to Contracting States) since that issue came within the domain of the European Union.

The French delegation has considered the precise meaning of the term “applicable law”, which appears in article 83 (4)(d), in relation to arbitration agreements.

This term would in fact seem to refer to the law governing the arbitration procedure and not the law applicable to the arbitration itself.

It is also felt that the wording of article 84 (2) on arbitration agreements in non-linear transportation could be improved and that the conditions under which arbitration agreements would be binding on third parties, in particular consignees, could be re-examined.

Several delegations have requested that the chapter on arbitration be excluded from the draft convention in that it limits the possibilities for resorting to arbitration.

The delegation of ICC France pointed out that the provisions on arbitration were of particular concern to ICC France.

Since document A/CN.9/WG.III/XVIII/CRP.3 had been distributed to delegates during the session, ICC France undertook to adopt a position subsequently.

The delegation of ICC France indicated that its position would be based on respect for freedom of contract and freedom to arbitrate, which are essential principles in the field of international trade.

Conclusion

ICC France notes with satisfaction the progress made in the work of UNCITRAL.

ICC France welcomes the fact that the principle of unqualified freedom to arbitrate has been reaffirmed by the Working Group.

ICC France believes, however, that some provisions, as currently worded, may limit the use of arbitration.

ICC France therefore requests the Working Group to take its observations into consideration.

**M. Note by the Secretariat on the preparation of a draft convention
on the carriage of goods [wholly or partly] [by sea] — Position of the
European Shippers' Council, submitted to the Working Group
on Transport Law at its nineteenth session
(A/CN.9/WG.III/WP.83) [Original: French]**

In preparation for the nineteenth session of Working Group III (Transport Law), the European Shippers' Council submitted to the Secretariat the document attached hereto as an annex containing its comments and proposals on provisions of the draft convention on the carriage of goods [wholly or partly] [by sea] scheduled for discussion during the session.

The document in the attached annex is reproduced in the form in which it was received by the Secretariat.

ANNEX

Introduction

1. With reference to the work of the eighteen session, which took place in Vienna, the European Shippers' Council wishes to present its analysis of those points which were simply discussed but not actually settled by consensus, in anticipation of the nineteenth session, to be held in New York in 2007.
2. The adopted positions set out below are based on the deliberations in Vienna and on main document A/CN.9/WG.III/WP.64, together with further specific work of official delegations, since to date we are neither aware of the consolidated version of the text following completion of the second reading nor in possession of the agenda for the New York session.

Limitation of liability

Article 64

3. The Council wishes the determination of the method of calculating the liability limit to take account of the actual value of the goods transported by sea. Rather than refer dogmatically to past systems, it seems preferable to take into consideration a value that is representative of current cargo flows and to use high-value flows as a basis (trade from Asia to the rest of the world).
4. The Council is very wary of the apparent extension of the scope of application of limitations of liability in relation to the Hague-Visby and Hamburg Rules.
5. The Council supports variant A of article 64 (2), which automatically applies the limitation that is most favourable to the shipper.

Article 65

6. While welcoming the fact that the principle of liability for delay on the carrier's part is still retained, the Council notes that the method of calculation

envisaged by some delegations at the eighteenth session, in Vienna, is still based on the amount of freight.

7. The Council again points out that this criterion, which was meaningful at the time of negotiation of the Hamburg Rules, in the 1970s, when freight rates were high (e.g. the Far Eastern Freight Conference (FEFC) rate of around US\$ 2,000/2,500 for a 20-foot container loaded with steel), has today lost its relevance owing to the volatility of rates, which have fallen to very low levels because of competition (e.g. the average freight-all-kinds (FAK) rate of US\$ 150-200 per 20-foot container for the Europe/Asia sector). The Council recommends abandoning a system whose only justification is tradition and advocates using a modern criterion in the future.

8. The Council proposes that the liability limitation rules applicable to both parties to the contract of carriage be unified:

- Either through the application of a blanket rule, as set out in article 64,
- Or through the principle of compensation for actual loss, being limited to a certain sum that is actually insurable in the case of the smallest operators.

In this latter context, the amount of 500,000 Special Drawing Rights (SDRs), proposed at a meeting of the eighteenth session by a consensus group led by the Swedish delegation, during discussions on the shipper's liability for delay, is in our opinion unjustified. We feel that a sum in the region of 80,000/100,000 SDRs is more realistic. That amount would represent the limit of liability of a carrier whose delay gives rise to a proven loss and the limit of liability of a shipper whose fault causes a loss.

9. However, without prejudice to the foregoing, should delegations by consensus adopt a method of calculation based on the amount of freight, the choice of a multiplier lower than that already existing in the Hamburg Rules (2.5 times the freight payable) would be an unacceptable backwards step for shippers benefiting from the most recent convention.

10. At the last session, held in Vienna, an informal group proposed, on the basis of document A/CN.9/WG.III/WP.74, a text relating specifically to the liability of the shipper whose fault causes delay. In essence the proposal denies the shipper the possibility of limiting its liability in two specific cases: where its fault give rise to damage to the ship or where a misstatement concerning its goods causes delay or loss.

11. Only in the very restricted case of the shipper's liability for delay whose cause is not related to a misstatement concerning the goods could it be limited, such limitation corresponding not to the formula "one or X times the freight payable" but to an amount arbitrarily fixed at 500,000 SDRs.

12. Such a proposal, which has no foundation in law, would defy any rule of symmetry and balance between the situation created for the carrier and for the shipper. The Council thus wishes to emphasize that retaining such a clause in the convention would have a negative impact on its support for the draft instrument and would influence shippers' attitude towards their respective Governments when the question of signing and ratifying the convention arises. It should also be noted that the Council finds it unacceptable that the text retains neither the formula in the Hague-Visby Rules (article IV (3)), nor that in the Hamburg Rules (article 12), whereby the shipper is not liable unless there is fault on the shipper's part.

13. The Council's rejection of the draft proposed by the informal group does not, however, mean, as suggested by some delegations, that it is abandoning its wish to retain the clause concerning the carrier's liability in the event of delay. That position is in line with the criteria of service quality that can justifiably be expected from transport providers engaged in global trade conducted under just-in-time and total quality principles.

14. The Council refuses to let itself be drawn into a quid pro quo scenario artificially created to enable carriers to reverse the achievements of the Hamburg Rules in regard to liability for delay.

Article 66

15. In the interests of consistency of interpretation by all legal systems, it is desirable to delete the word "personal" from the English version, which limits cases of liability. That restrictive element is incompatible with the expectations of shipper customers from their transport providers, who are increasingly assuming a major player position in a modern maritime world.

16. The Council also feels very reluctant regarding the apparent extension of the scope of application of the circumstances recommended in article 66 where the carrier does not lose the right of liability limitation.

Article 89: Other conventions

17. The Council supports the analysis made by the International Road Transport Union (IRU) and shares the concerns expressed by it from a multimodal perspective, whose significance it is important to recognize.

18. We consider it desirable to retain article 27 (but delete article 90, which is harmful) and to retain and modify article 89. The Council is not opposed to a neutral multimodal instrument of global application but is primarily in favour of simple solutions offering good predictability. From that viewpoint, it might consider accepting a single system of liability and compensation but such a position has limits and is valid only if genuine equality of treatment is established in the convention. The instrument as it now stands is so unbalanced to the detriment of shippers that, regrettably, the Council feels compelled at this stage to call for the application of unimodal transport conventions for the non-maritime legs, since such conventions are far more protective of shippers' interests.

Articles 75 and 76: Jurisdiction

19. On the question of designating courts, the Council is primarily seeking predictability and simplicity and accordingly favours an article that gives a specific list of standard places for determining competent courts, in particular those traditionally associated with the transport operation. It would also be desirable to include the place of formation of the contract.

20. The fullest possible list is preferable to the system adopted, which combines a list of locations and total freedom of choice.

21. Such freedom of choice of jurisdiction encourages forum-shopping, which could lead to the designation of places of jurisdiction outside the list of proposed locations and even allow the designation of a court in a country that has not acceded to the convention.

22. The Council feels that freedom of contract (cf. below) granted to the contracting parties should be limited to the possibility of choosing by agreement a basis of jurisdiction from among those appearing in the list in article 75 (a), (b) and (c).

23. The criteria in article 76 (2) (a), (b) and (c) allowing total derogation from article 75 (a), (b) and (c) are not sufficient to justify such a derogation. The definition of the volume contract, on which the right to derogate from the provisions of the instrument is based, is too general. Only substantial strengthening of the definitional criteria concerning the volume contract would make it possible to justify such an extensive derogation.

24. The Council also stresses the need to protect the consignee. From this perspective, paragraph 3 of article 76 does not provide the desired safeguards. It would be necessary to add to paragraph 3 a clause providing for express acceptance of the choice of forum by the consignee, failing which the consignee would be entitled to impose, at its option, one of the places listed in article 75.

25. Again in the interests of predictability, the rules for designating competent courts contained in the convention should be binding on all signatory countries. A convention that allows for an opt-in or opt-out system (article 76 (4)) will needlessly complicate the convention's implementation. The Council does not therefore support the provisions included or put forward by delegations during the discussions on article 76 (4) at the eighteenth session.

26. The Council notes that there is no mention of judicial proceedings against the shipper. In the interests of balance and reciprocity, that point should be specified.

Remarks on contractual freedom

27. The Council recalls the extreme reservations that it was prompted to make in its previous statement of position (A/CN.9/WG.III/WP.64) concerning some delegations' stance in favour of total freedom of contract, which would be harmful to small and medium-sized shippers. Its position on articles 75 and 76 reinforces its misgivings regarding freedom of contract based solely on insufficient definition of the volume contract. It should be noted that the Hague and Hamburg Rules allow very broad freedom of contract while protecting small and medium-sized shippers. By simply reproducing their well-known provisions and excluding derogations in favour of the carrier alone, it would be possible to dispense with the entire, poorly constructed volume contract mechanism.

Conclusions

28. With the second reading of the draft instrument now completed, it has to be acknowledged that the Council, disappointed by the loss of direction of a text whose developments have more to do with reversing the achievements of the Hamburg Rules than endeavouring to modernize intermodal transport law, questions the usefulness of such an instrument in dealing with freight transport in the coming decades.

29. The lack of balance in the main provisions, in particular those concerning rules of liability, is now such that the Council is pessimistic about any possible realignment of the main areas of imbalance by the time of completion of the work. It will nevertheless be present in a constructive spirit at the next session, in New York, in an attempt to save what can still be saved.

30. The European Shippers' Council is the organization which represents the interests of European industrial and commercial companies as users of all modes of transport. "Shippers" are primarily producers or distributors of goods, which they market and distribute to their customers. Carriage by sea is their main mode of transport in international trade.

N. Note by the Secretariat on the preparation of a draft convention on the carriage of goods [wholly or partly] [by sea] — Proposal of the United States of America on the definition of “maritime performing party”, submitted to the Working Group on Transport Law at its nineteenth session

(A/CN.9/WG.III/WP.84) [Original: English]

In preparation for the nineteenth session of Working Group III (Transport Law), the Government of the United States of America submitted to the Secretariat the proposal attached hereto as an annex with respect to the definition of “maritime performing party” in the draft convention on the carriage of goods [wholly or partly] [by sea].

The document in the attached annex is reproduced in the form in which it was received by the Secretariat.

ANNEX

Proposal of the United States of America on the definition of “maritime performing party”

As set out in footnote 9 of A/CN.9/WG.III/WP.81, it has been suggested that the definition of “maritime performing party” (draft article 1 (7) of the draft convention) should be edited to clarify that a rail carrier, even if it performs services that might be considered the carrier’s responsibilities after the arrival of the goods at the port of loading or prior to the departure of the goods from the port of discharge, should be considered a non-maritime performing party.

The convention applies to actions against the carrier or a maritime performing party (draft article 4), but not to actions against a non-maritime performing party. The suggestion outlined in paragraph 1 was made at the behest of the Association of American Railroads (AAR) (representing U.S., Canadian, and Mexican railroads). The AAR has made it known to the United States from the beginning of this negotiation that it is concerned that it might inadvertently be deemed to be a maritime performing party when it performs services within a port area, even though the ultimate purpose of those services will virtually always be to move goods into or out of a port and not to move goods from one place to another within a port. Therefore, the United States supports the suggestion reflected in paragraph 1.

The United States proposes that the following sentence be added at the end of draft article 1 (7) of A/CN.9/WG.III/WP.81 (the definition of “maritime performing party”):

“A rail carrier, even if it performs services that are the carrier’s responsibilities after arrival of the goods at the port of loading or prior to the departure of the goods from the port of discharge, is a non-maritime performing party.”

O. Note by the Secretariat on the preparation of a draft convention on the carriage of goods [wholly or partly] [by sea] — Shipper's Obligations: Drafting proposal by the Swedish delegation, submitted to the Working Group on Transport Law at its nineteenth session

(A/CN.9/WG.III/WP.85) [Original: English]

In preparation for the nineteenth session of Working Group III (Transport Law), the Government of Sweden submitted to the Secretariat the paper attached hereto as an annex with respect to liability for delay in the draft convention on the carriage of goods [wholly or partly] [by sea]. The Swedish delegation advised that the paper was intended to facilitate consideration of the topic in the Working Group by proposing revised text for some of the provisions on liability for delay. The Swedish delegation further advised that the revised text and commentary in the attached annex was prepared in light of the consideration of the topic of shipper's obligations by the Working Group during its eighteenth session, and on the basis of further informal consultations with other delegations. The Working Group may wish to consider the text in the attached annex in its further consideration of the provision on liability for delay of the draft convention.

ANNEX

Liability for delay in the Draft convention on the carriage of goods [wholly or partly] [by sea] — a possible compromise solution

I. Introduction

1. At the eighteenth session, the Working Group decided that the approach to the treatment of liability for pure economic loss or consequential damages caused by delay on the part of the shipper or the carrier set out in "option three" (as described in A/CN.9/WG.III/WP.74) should be pursued as the optimal approach for the draft convention, subject to the Working Group's ability to identify an appropriate method to limit the liability of the shipper for pure economic loss or consequential damages caused by delay (A/CN.9/616, paras. 92, 93 and 100). During that session, the Swedish delegation presented a compromise solution on that matter. However, a number of delegations asked for a written presentation of that compromise proposal. The Swedish delegation has taken on the task to produce such a presentation in order to facilitate the future debate on this matter. The proposal is based on the consolidated text of the draft convention in document A/CN.9/WG.III/WP.81.

II. Carrier's liability for delay caused by a shipper — the question of causation

2. As explained in A/CN.9/WG.III/WP.74, paragraph 14, the intention behind the regulation of delay in the draft convention is that the carrier would never become liable to one shipper for a delay caused by an act or omission of another shipper. For example, if shipper A claims compensation from the carrier because of the fact that

the discharge of the goods from the vessel was delayed in the port of destination, the carrier will in this situation be relieved from liability provided that it can prove that the delay was not due to fault on the carrier side, but to the fact that shipper B did not submit the documents required. Shipper B cannot in this situation be considered as a servant or contractor for whom the carrier is responsible.

3. However, at the eighteenth session, some delegations were concerned that carriers would nevertheless be found liable under the draft convention for a delay caused by one shipper in relation to all other shippers with goods on board that vessel (A/CN.9/616, para. 103). In order to accommodate the needs of those delegations, a clarification that the carrier would not be liable for loss or damage to the extent that it is attributable to an act or omission of another shipper could be added in draft article 18 as a new paragraph 3. Such a clarification could read as follows:

Article 18. Liability of the carrier for other persons

1. The carrier is liable for the breach of its obligations pursuant to this Convention caused by the acts or omissions of:

(a) Any performing party; and

(b) Any other person, that performs or undertakes to perform any of the carrier's obligations under the contract of carriage, to the extent that the person acts, either directly or indirectly, at the carrier's request or under the carrier's supervision or control.

[2. The carrier is liable pursuant to paragraph 1 of this article only when the performing party's or other person's act or omission is within the scope of its contract, employment, or agency.]

3. The carrier is not liable to a shipper or a consignee for any loss or damage to the extent this is attributable to an act or omission by another shipper.

4. A concern that might be raised against the proposal to insert such a clarification in draft article 18 is that such a rule is already contained in draft article 17 (1) where it is regulated that the carrier is relieved of its liability if it can prove that the loss, damage or delay is not attributable to its fault or to the fault of any person whom it is responsible for according to draft article 18 (A/CN.9/616, para. 104). However, there is a risk, at least in some jurisdictions, that draft article 17 might be interpreted to the effect that the carrier would be found liable anyway in relation to a shipper having goods on board the ship, perhaps for an overall failure to put into place systems to prevent delays caused by another shipper. In such a situation, a clarification of this kind might be helpful.

III. Limitation of the shipper's liability for delay

5. At the eighteenth session of the Working Group, some delegations raised concerns about the potentially very high exposure to liability for the shipper, especially regarding pure economic loss (A/CN.9/616 paras. 105 and 106). One way of limiting this exposure is to put a cap on the liability of the shipper regarding economic loss due to pure delay as a result of a breach of the obligations in draft articles 27, 29 and 31, para. 1. This would make the risk exposure in case of a pure delay more predictable and, as a consequence of this, insurable. For economic loss due to the fact that the shipper is in breach of its obligations regarding accuracy of

information and dangerous goods in draft articles 31, para. 2, and 32 it will still be fully liable regardless of whether there is a pure delay or not. The reason for not putting a cap on the liability for a breach of one of these obligations is that they are considered that vital to the carrier that a shipper who disregards them does not deserve the protection of a limitation of liability. In respect of breaches of its obligations under draft articles 27, 29 and 31, paragraph 1, the shipper will also be fully liable for consequential loss resulting from physical damage to the vessel, other cargo or personal injury. Regarding liability for physical damage to the vessel, other cargo or personal injury, a shipper already currently has unlimited liability according to both the Hague Visby Rules and the Hamburg Rules and this seems not to have caused any problems in practice.

6. If it is decided that the shipper's liability for pure delay should be limited, it becomes necessary to make sure that the limitation level does not apply to the obligation to pay demurrage or damage for the detention of the vessel arising out of charterparties or other transport contracts outside the scope of the draft convention.

7. It has proved difficult to link the limitation level to the weight or value of the goods or to the freight. Neither of these factors correspond with the risk. For example, a shipper, who is shipping waste might cause the same damage as a shipper who is shipping electronic equipment. Therefore, it seems preferable to establish a fixed sum as the limitation level. Such a type of liability could also be easily incorporated as a liability element in cargo insurance. Regarding the amount of the cap, an overall objective should be that the limitation level ensures that shippers are fully liable in ordinary cases, at the same time as they are protected from excessive exposure in extraordinary cases in order to make the liability insurable. If a limitation level of 500,000 SDR is established, approximately between 260 and 320 claims for full freight from other shippers would be covered, based on the fact that the average freight rate of a container amounts to between 1,500 to 3,000 US dollars. A provision establishing such a limitation level could read as follows:

Article 30 ter. Limitation of shipper's liability for loss caused by delay

1. In case of economic loss due to delay, other than as a result of loss or damage to the vessel, other cargo or personal injury, the liability of the shipper for breaches of its obligations under this chapter, except for articles 31, paragraph 2, and 32, is limited to an amount equal to [500,000] SDR per incident.

2. Paragraph 1 does not apply to obligations to pay demurrage or damage for the detention of the vessel arising out of charterparties or other transport contracts outside the scope of this Convention[, incorporated into a transport document or electronic transport record].

IV. A general regulation regarding causation

8. At the eighteenth session, some delegations also indicated that there might be a need for the inclusion of a more general provision on causation in case of liability for delay in order to safeguard that general principles on this in national law are not affected (A/CN.9/616 paras. 107 and 108). Other delegations were of the view that such a provision was not necessary because of the fact that if the draft convention is silent, it follows automatically that national law applies. However, it could be argued that the mere regulation of the shipper's liability in chapter 8 might lead to the result that principles on causation established in national law would be

undermined. A provision on causation has to be restricted on the carrier's side to cover only liability due to delay. Otherwise such a provision would be in contradiction with the carrier's right to limit the liability to the value of the goods in case of loss of or damage to the goods. A possible solution that the Working Group might wish to consider is to add a new paragraph (para. 4) to draft article 22. The article would then read as follows:

Article 22. Calculation of compensation

1. Subject to article 62, the compensation payable by the carrier for loss of or damage to the goods is calculated by reference to the value of such goods at the place and time of delivery established in accordance with article 11.
 2. The value of the goods is fixed according to the commodity exchange price or, if there is no such price, according to their market price or, if there is no commodity exchange price or market price, by reference to the normal value of the goods of the same kind and quality at the place of delivery.
 3. In case of loss of or damage to the goods, the carrier is not liable for payment of any compensation beyond what is provided for in paragraphs 1 and 2 of this article except when the carrier and the shipper have agreed to calculate compensation in a different manner within the limits of chapter 19.
 4. Subject to article 63, economic loss due to delay in delivery of the goods is calculated according to rules and principles established under applicable national law.
9. The corresponding provision on the calculation of the loss due to the fault of the shipper will have to form a new article in chapter 8 on shipper's obligations. However, this provision should not be restricted to economic loss due to delay, but should apply to all types of loss and damage. Such a provision might read as follows:

Article 30 bis. Calculation of compensation

Subject to article 30 ter, loss or damage due to the breach of any of the shipper's obligations under this chapter is calculated according to rules and principles established under applicable national law.

**P. Note by the Secretariat on the preparation of a draft convention
on the carriage of goods [wholly or partly] [by sea] — Proposal
of the delegations of Denmark, Norway and Finland on draft
article 37 (1)(a) regarding contract particulars, submitted to the
Working Group on Transport Law at its nineteenth session
(A/CN.9/WG.III/WP.86) [Original: English]**

In preparation for the nineteenth session of Working Group III (Transport Law), the Governments of Denmark, Norway and Finland submitted to the Secretariat the proposal attached hereto as an annex with respect to draft article 37 (1)(a) on contract particulars in the draft convention on the carriage of goods [wholly or partly] [by sea].

The document in the attached annex is reproduced in the form in which it was received by the Secretariat.

ANNEX

Contract particulars

1. Under draft article 37 (1)(a) the carrier is obliged to include a “description of the goods” as furnished by the shipper. The carrier may, however, protect itself by entering a reservation on the document if it has no physically practicable or commercially reasonable means of checking the accuracy of the information (see draft article 41 (2)(a)). In any event, the carrier must include the information provided by the shipper. The draft convention provides no limits as to the amount of information, the nature of the information, descriptions, etc. which the shipper may require to have included in the transport document. This is new as compared to the equivalent provision in the Hague, Hague-Visby and Hamburg Rules.

2. In practice, there is an increasing tendency of shippers to provide lengthy and detailed technical descriptions of the goods which they ask to have included in the transport document. It is important that the draft convention provides for a limit as to the length, nature and degree of detail of the information that the shipper may require to have included in the transport document. If such a limit is not provided for, the carrier is obliged to perform a reasonable checking of all such information furnished by the shipper which it is physically practicable and commercially reasonable to check (see draft article 41 (2)(a)). When a considerable amount of information or information of a specific nature is to be included in the transport document, it will often be a matter of opinion — and therefore give rise to disputes — whether such checking will be physically practicable or commercially reasonable. By permitting too many and too detailed particulars in the transport documents, compliance with the obligation of the carrier to exercise a reasonable control of those particulars is made significantly more difficult and burdensome. One element is the increased insecurity connected with reading several pages of information; another is that the way is paved for including particulars remote or even unrelated to the contract of carriage and hence unfamiliar to the carrier. In

addition, it may adversely affect the standard of reasonableness to be applied to the carrier.

3. In order to meet these concerns it is suggested that the following amendment be made in the text:

Draft article 37 (1)(a) should be altered to read as follows: “A description ***in general terms*** of the goods;”.

This proposal is based on the wording of UCP 600 (Uniform Customs and Practice for Documentary Credits (6th revision)), Article 14 (e), which ensures that the transport document will still fulfil its purpose in international trade. It is also quite similar to the solution in the Hamburg Rules, Article 15 (1)(a) which speaks of “the general nature of the goods”.

Q. Note by the Secretariat on the preparation of a draft convention on the carriage of goods [wholly or partly] [by sea] — Comments of the International Chamber of Shipping (ICS), BIMCO and the International Group of P&I Clubs on the draft convention, submitted to the Working Group on Transport Law at its nineteenth session

(A/CN.9/WG.III/WP.87) [Original: English]

In preparation for the nineteenth session of Working Group III (Transport Law), the International Chamber of Shipping (ICS), BIMCO and the International Group of P&I Clubs submitted to the Secretariat the document attached hereto as an annex containing their comments on the draft convention on the carriage of goods [wholly or partly] [by sea] (A/CN.9/WG.III/WP.81) scheduled for discussion during the session.

The document in the attached annex is reproduced in the form in which it was received by the Secretariat.

ANNEX

Comments of the International Chamber of Shipping (ICS), BIMCO and the International Group of P&I Clubs on the draft convention (A/CN.9/WG.III/WP.81)

Introduction

International Chamber of Shipping (ICS), BIMCO and the International Group of P&I Clubs (collectively referred to as “we”) have the following comments on the draft convention on the carriage of goods [wholly or partly] [by sea] as contained in UNCITRAL document A/CN.9/WG.III/WP.81.

Draft Article 6 — Specific exclusions

Draft Article 6(1)(b)

Delete “Contracts” and replace with “Other contractual arrangements ...”

Draft Article 6(2)(a)

Delete “contract” and replace with “other contractual arrangement between the parties”. After “thereon” delete “between the parties, whether such contract is a charterparty or not”.

Rationale: The above suggestions for amendment are in order to clarify the text.

Draft Article 12 — Transport not covered by the contract of carriage

The words in the first parenthesis are strongly preferred.

Rationale: The carrier may wish to assist with shipper requests for pre-carriage or onward carriage. Such service would be most efficiently provided using a through transport document but in such a case, the carrier should act only as agent for the shipper in respect of the pre-carriage or onward carriage so that it remains at the shipper's risk and responsibility. This practice is in widespread use, ensuring a smooth accomplishment of international trade with appropriate delineation of risk. If the second parentheses are chosen, then many carriers may not agree to arrange pre-carriage or onward carriage as agents and will only contract for the whole of the combined transport. The second parenthesis thereby discourages flexibility and that is not helpful to carriers or shippers.

Draft Article 17 — Basis of liability

Draft Article 26 — Carriage preceding or subsequent to sea carriage

The words “event or circumstance” should be replaced with “occurrence” wherever they appear in these articles.

Rationale: The word “circumstance” is too broad in scope and not appropriate for the intention of these articles and the use of both “event” and “circumstance” is unnecessary and otiose. “Occurrence” is more in line with the meaning and intention of the clause and should replace the present wording.

Draft Article 18 — Liability of the Carrier for other persons

Draft Article 18(2) — Lift the parentheses.

Rationale: As a matter of principle, it is important that the carrier's liability for the actions of its agents, employees and sub-contractors is limited to when the party is acting within the scope of its employment or contract or duty. See also the suggestion under draft article 19 below.

Draft Article 19 — Liability of maritime performing parties

Draft Article 19(4) — We support the principle behind this article but believe that it is more appropriately placed in an independent article and it should be expanded to include the full category of parties that perform the carrier's obligations under this convention.

Rationale: The employee, agent and sub-contractor of the carrier and the maritime performing party, should be afforded the full protection of the rights, defences and limits of liability available to the carrier under this convention for any breach of its contractual obligations or duties in the event that an action under the draft convention is made directly against it (a “Himalaya” clause). This draft article upholds this principle but since it, rightly, encompasses a wider range of parties than the heading of this draft article (maritime performing parties), it is more appropriate for it to be an independent article.

Finally, we suggest that the clause includes a provision similar to draft article 19(2) but extended to the carrier, performing party and maritime performing party.

Draft Article 26 — Carriage preceding or subsequent to sea carriage

Draft Article 26(1) — The reference to “national law” in the preamble to the draft article should be deleted.

Draft Article 26(1)(a) — Variant B is preferred with the reference to “national law” in parentheses, deleted.

Rationale: Only those regulations contained in international conventions or instruments should be able to prevail over the terms of this draft convention since these provisions will be easily and readily identifiable. To allow national law provisions, wherever and whatever they may be, to prevail would create considerable uncertainty as to the extent of carrier’s and shipper’s liability. Variant B of draft article 26(1)(a) is preferred since it contains more restricted criteria for the circumstances that must exist before the draft convention can be ousted and it introduces the factor of relevance.

Draft Article 27 — Delivery for Carriage

Draft Article 27(2) — Delivery for Carriage

We would suggest supporting the deletion of the square brackets around draft article 27(2).

Rationale: When the shipper agrees to perform the operations listed in draft article 14(2), it is right to impose an obligation that they are performed with the same standard of care as the draft convention imposes on the carrier, namely in draft article 14(1).

Draft Article 32 — Special rules on dangerous goods

Draft Article 32 (a) — We support the deletion of the square brackets around “the carriage of such goods” and deleting the words “such failure to inform” in the final line of the paragraph.

Rationale: The carrier stands exposed to enormous loss and damage if dangerous goods are loaded on to his vessel without his knowledge and consent. It is only reasonable, therefore, for the carrier to be afforded the widest protection in these circumstances and the shipper should then be liable for all consequences of such goods having been loaded and carried.

Draft Article 37 — Contract particulars

Draft Article 37(1)(a) — “A description of the goods” could lead to a shipper inserting a very lengthy and detailed description. We wonder therefore whether there should be words here to limit the extent of the goods’ description.

Draft Article 38 — Identity of the carrier

Draft Article 38(2) — We have strong objection to any presumption as is proposed in draft article 38(2) and therefore both Variant A and B should be deleted.

Rationale: Where the registered owner is a separate entity from the ship operator, the registered owner will rarely have any practical influence over the operation of the vessel and, indeed, is often a financial institution. Industry maintains that a shipper is in the best position to ascertain the identity of the contracting carrier, and parties acquiring bills of lading should not be placed in a better position than the shipper. As draft article 37(2)(b) now contains an obligation on the shipper to specify the name and address of the carrier and it is agreed in draft article 38(1) that any statements to the contrary elsewhere in the transport document will have no

legal effect, any ambiguity thereafter is more appropriately dealt with by the courts under the applicable law and not by the draft convention.

Draft Article 41 — Qualifying the description of the goods in the contract particulars

Draft article 41 is of very great practical importance to carriers. It is vital that carriers know when and how to make a qualification: in order to avoid any uncertainty in this respect, draft article 41 should be somewhat restructured and rephrased. In particular, it should more clearly set out the distinction between cases where a qualification shall be made and cases where a qualification may be made. Additionally, it would appear from the scheme of the article that the qualification to be made under sub-paragraph 1 is more in the nature of a “correction” of the shipper’s statements whereas the qualifications to be made under sub-paragraphs 2 and 3 respectively are more in the nature of a “reservation” of rights. We would suggest that this distinction is made clearer in the article. In particular, whereas the word “qualify” is appropriate in paragraph 1, the word “reservation” should be used in paragraphs 2 and 3. Draft article 41(1)(a) is also a little unclear in that there is a reference twice to “material”. Is this intended, and if so, is there any reason why the same phraseology has not been used in draft article 41(1)(b)? Furthermore, we would request clarification as to the difference between “materially false” and “false”.

Draft Article 42 — Evidentiary effect of the contract particulars

We are strongly opposed to draft article 42(b)(ii) since it proposes to extend the conclusive evidentiary effect of the statements in a transport document not only to all non-negotiable transport documents transferred to a consignee and where that transport document has to be presented in order to take receipt of the goods, but also to sea waybills.

In commercial practice the distinction referred to in the last sentence of draft article 42 (c) is of no practical use.

Rationale: As a matter of principle, conclusive evidence should only attach to negotiable documents where a third party buyer of goods relies on the terms of the negotiable document when acquiring the goods. Where there has been no such reliance on the statements in the transport document, there is no reason why a consignee of a non-negotiable document should be placed in a better position than the shipper. Having said that, the draft convention should be flexible and recognize the parties’ freedom to contract on terms that are commercially agreeable. An acceptable compromise solution therefore could be to give conclusive evidentiary effect to statements in non-negotiable documents where the parties so agree by a statement on the face of the document.

Draft Article 46 — Delivery when no negotiable transport document or negotiable electronic record is issued

Draft Article 46 (c) — Delete the words “after having received a notice of arrival”

Rationale: We recall that it had been agreed that there should not be an obligation in all circumstances to give a notice of arrival and, indeed, a corresponding obligation does not appear in the subsequent articles. It may be, therefore, that the appearance of the obligation in this article is an oversight and should be deleted.

Draft Article 49 — Delivery when negotiable transport document or negotiable electronic transport record is issued

Draft Article 49(f) — Add after “other than the right to claim delivery of the goods”, the words “or compensation for the failure to deliver the goods”.

Rationale: It is arguable that the present wording whilst excluding the right to claim delivery of the goods does not exclude the right to claim losses or damages for failure to deliver the goods. The proposed amendment is intended to exclude such claims.

Draft Article 49 (g) — This provision should be deleted.

Rationale: It is of great practical importance that delivery which takes place according to the provisions in draft article 49 (a) to (d) should release the carrier from any further obligations as to delivery. A transport document holder who acquires it in good faith after delivery has taken place may acquire other rights, but not a right to claim delivery or a right to claim loss or damage for failure to deliver the goods. This principle is accepted in draft article 49 (f) and it is difficult to understand why the mere fact of lack of knowledge of the delivery at the time of becoming holder should justify a departure from this important principle in draft article 49 (g). If draft article 49 (g) is retained, there is a risk that the holder at the time of delivery may simply transfer the transport document to another person acting in good faith and thereby resurrect the right to claim delivery.

Draft Article 50 — Goods remaining undelivered

Draft Article 50(5) — This provision should be amended in order to more clearly set forth the liability of the carrier.

Rationale: The carrier should be liable according to an ordinary fault liability rule with the burden of proof on the claimant. This liability should be related not only to preservation of the goods, but to any steps taken by the carrier under draft article 50(1). Such a rule should be supplemented with a special rule under which a carrier is not liable for damage to the goods or other loss or damage which is a consequence of the goods not being received by the consignee, provided the goods have been handed over to a suitable terminal authority, public authority or other independent person or authority who takes care of the goods. Often destruction or sale of the goods are no real alternatives, therefore the carrier should be provided with alternative ways to be relieved of a continuing liability. Alternatively, an extended concept of delivery could be introduced under which the goods are deemed delivered, if it is handed over to such authority, etc. Compare the principles in draft article 11(3) and draft article 55.

Draft Article 54 — Carrier’s execution of instructions

Draft Article 54(4) — Lift the parentheses.

Rationale: It is preferable for reasons of harmonization of liability rules, for liability under this article, including liability for delay, to be dealt with under the convention rather than leaving it to national law.

Draft Article 60 — Liability of holder

Draft Article 60(2) — The words in the first parentheses are preferred.

Rationale: These words are clearer in the drafting and more comprehensive as to the liabilities to be assumed by the holder. Furthermore, as these liabilities are those that are actually incorporated in or ascertainable from the transport document, it is also fairer to the holder, rather than having liabilities imposed on him through the convention of which he may not be aware, as is the case with the words in the second parentheses.

CHAPTER 12 — TRANSFER OF RIGHTS

This chapter provides clarity regarding as to who can provide instructions to the carrier as to delivery of the cargo and serves a very useful purpose by harmonising national laws in an area where quite different rules apply worldwide. Harmonization would greatly facilitate international trade and this chapter is therefore supported.

Draft Article 62 — Limits of liability

Draft Article 62(1) — The decisions already agreed in relation to carrier's liability should be borne in mind. In particular, it has been agreed: (a) to exclude the exception of error in navigation; (b) that the carrier shall exercise due diligence to make the vessel seaworthy throughout the voyage rather than to limit this obligation to the commencement of the voyage; and (c) that the carrier is liable for delay. The sum result of all these changes has been to radically alter the scheme of liability so that the carrier will be liable in most cases. This will have a serious economic impact on shipowners and their insurers and is very relevant when it comes to deciding levels of limits of carrier's liability.

From the point of view of ensuring adequate compensation, claims experience demonstrates that the overwhelming majority of claims fall within current liability levels in the Hague-Visby Rules (see footnote 2 of A/CN.9/WG.III/WP.34) and no evidence to the contrary has been adduced. It should not be forgotten that the draft convention contains a mechanism to increase any limits of liability should they be found to be insufficient by the tacit amendment procedure in draft article 99 which will be of great practical importance. Moreover, in the event that a cargo is high value, the shipper should be encouraged to declare the value in the bill of lading and for the freight to be adjusted accordingly.

In addition, the concept of "ad valorem" freight is still supported.

Draft Article 62(2) — Substitute Variant A and B for a provision that where the place of damage is not known, the liability rules and limits of liability under the draft convention shall apply.

Rationale: Any contract of carriage falling under the draft convention must include a maritime leg, and in most transports falling under the draft convention the maritime leg will be the most important leg time-wise and lengthwise. Under these circumstances it would be quite logical to apply the liability and limitation rules of the maritime leg for concealed damage. Increased liability for concealed damage may deter maritime carriers from offering multimodal transport documents and lead to increased insurance costs.

Draft Article 63 — Limits of liability for loss caused by delay

The draft convention text should include liability for delay causing economic loss by both carrier and shipper with an appropriate cap on the liability for each party.

Rationale: At the 18th session of the Working Group in Vienna 2006, the Working Group expressed support for the third option put forward by Sweden in A/CN.9/WG.III/WP.74, namely that the draft convention should include a capped liability for delay for both shipper and carrier subject to agreeing an appropriate method to limit the shipper's liability. Industry strongly supports this option as it represents equal treatment of parties which is an important principle to uphold in the draft convention if it is to gain wide support. As to the cap on liability, industry supports the proposal canvassed at the 18th session that this should be one times the freight for the carrier and USD 500,000 for the shipper. In addition, in support of the parties' freedom of contract, the parties should have the right to be able to adjust the cap on liability by the use of a phrase such as "unless otherwise agreed".

CHAPTER 15 — JURISDICTION

We are in favour of a modification whereby inclusion of the jurisdiction chapter would be optional. We support the proposal that this is achieved through a partial opt-in provision which preserves the right of states incorporating the jurisdiction provisions to determine whether, in accordance with their legal policy, to give effect to an exclusive choice of court agreement in respect of any contract, that is, partial opt-in.

CHAPTER 16 — ARBITRATION

Draft Article 78 — Arbitration agreement in liner transportation

This should include a partial opt-in provision similar to draft article 70(3) under the chapter on jurisdiction.

Rationale: It was agreed at the 18th session of the Working Group in Vienna 2006 that if the approach now being put forward in relation to jurisdiction is developed in respect of liner trades, it is essential to replicate the partial opt-in provisions suggested there also with regard to arbitration so that a designated arbitration agreement could be given effect and upheld equally in a state which would recognize an exclusive choice of court agreement. Moreover, rights under an arbitration agreement should be a two-way process, allowing for action both by and against a carrier.

Draft Article 79 — Arbitration agreements in non-liner transportation

Bulk trades are expressly excluded from the arbitration provisions. Nevertheless, it should be made clear that a jurisdiction clause in a charterparty is accorded the same status as a charterparty arbitration clause.

Draft Article 88 — General provisions

Paragraphs 1 and 2 should fully match each other in scope.

Draft Article 99 — Amendment of limitation amounts

The tacit amendment procedure of the limits of liability is an extremely important aspect of the draft convention and one which will ensure its relevance and ability to meet changing situations and is therefore strongly supported. It is submitted that the provisions in this draft article should also extend to shipper's limits of liability for delay.

R. Note by the Secretariat on the preparation of a draft convention on the carriage of goods [wholly or partly] [by sea] — Joint proposal by Australia and France concerning volume contracts, submitted to the Working Group on Transport Law at its nineteenth session (A/CN.9/WG.III/WP.88) [Original: English/French]

In preparation for the nineteenth session of Working Group III (Transport Law), the Governments of Australia and France submitted to the Secretariat the proposal attached hereto as an annex concerning volume contracts in the draft convention on the carriage of goods [wholly or partly] [by sea].

This note and document A/CN.9/612 refer to articles in the draft convention as they appeared in document A/CN.9/WG.III/WP.56 and not as they appear in the revised version of the draft convention (A/CN.9/WG.III/WP.81). The proposals are in addition to the ones contained in document A/CN.9/612. The document in the attached annex is reproduced in the form in which it was received by the Secretariat.

ANNEX

Joint proposal by Australia and France concerning volume contracts

Proposals concerning volume contracts

In document A/CN.9/612, replace paragraph 12 with the following:

“12. It would be preferable to clarify the definition of volume contract given in draft article 1 (b) as follows:

‘Volume contract’ means a contract of carriage negotiated by the parties by which a carrier agrees to special terms for the carriage of a substantial quantity of cargo, in a series of shipments during a set period of time of no less than one year. The quantity may be specified as a minimum, a maximum or a certain range.”

After paragraph 12 in document A/CN.9/612, insert the following and renumber the remaining paragraphs:

“13. The proposed definition clarifies the concept of volume contract under the Convention. The specific feature of this type of contract is that it is negotiated between the parties taking into account that they are committed over a long period of time and for a large quantity. It can thus be distinguished from a contract of carriage that normally is a standard form contract, since the bill of lading is not discussed but only signed by the shipper. The long period of time and the large quantity are what justify allowing derogations to the Convention under article 89 (last version).”

S. Note by the Secretariat on the preparation of a draft convention on the carriage of goods [wholly or partly] [by sea] — Proposals of France, submitted to the Working Group on Transport Law at its nineteenth session

(A/CN.9/WG.III/WP.89) [Original: French]

In preparation for the nineteenth session of Working Group III (Transport Law), the French delegation submitted to the Secretariat its proposals regarding the linkage between the draft convention on the carriage of goods [wholly or partly] [by sea] and the conventions on other modes of transport.

The document in the attached annex contains these proposals in the form in which they were received by the Secretariat.

ANNEX

Proposals of France regarding the linkage between the draft convention on the carriage of goods wholly or partly by sea and the conventions applicable to land or air transport

Comments

The provisions which deal with the linkage between the UNCITRAL draft instrument on the carriage of goods wholly or partly by sea and the other modal conventions are currently distributed among four articles in three different chapters (articles 27, 64 (2), 89 and 90 in chapters 3, 13 and 19). In view of the close connection between these provisions, and in order to make the text more reader-friendly, it is proposed that articles 27, 64 (2) and 89 be merged to form a single article in the chapter “Other Conventions”, replacing the current article 89. Article 90 would be deleted.

In the merging of articles 27, 64 (2) and 89, a number of editorial changes have been made in the consolidated draft article:

- In paragraph 1 of the new article, the expression “... loss of or damage to [goods] or delay occurring during”, deemed too vague, has been replaced by “When ... the cause of such loss, damage or delay occurs ...”.
- Paragraph (b) of article 27 was deemed to be superfluous, as the need to determine a linkage between the liability regime of the UNCITRAL convention and another convention should arise only insofar as the other convention has its own liability regime.
- In the context of a consolidated version, it was not deemed useful to retain paragraph 2 of article 27, which states that paragraph 1 of article 27 does not affect the application of article 64, paragraph 2. Paragraph 2 of article 64 has become paragraph 2 of the new article, and the wording proposed for this

paragraph specifies that it applies “notwithstanding paragraph 1”. This reiterates the provisions in article 27.

- There is no obvious need for paragraph 3 of article 27, which reads: “This article applies regardless of the national law otherwise applicable to the contract of carriage”. This paragraph has therefore not been retained in the consolidated draft.
- Paragraph 3 of the new article reiterates the substance of article 89 in a more explicit form. It was not considered necessary to retain the reference to article 92. Furthermore, the wording “which is already in force ... at the date of this Convention” has been deleted from the proposed draft: a convention cannot pre-empt the choices that might be made by the drafters of a future convention. Such a provision would only limit the options available to future legislators, which is unacceptable.

It is also proposed that article 90 be deleted, as the Working Group appears to have wished at its latest session. This article would seem to be potentially in conflict with article 89. The deletion of article 90 will make it more certain that implementing the UNCITRAL draft convention will not lead to conflicts between the convention and the existing modal instruments.

We note that the expressions *loading* and *discharge* in paragraph 1 of the consolidated proposal could give rise to difficulties of interpretation. These expressions are not defined in the convention. The application of paragraph 1 might require reference to the provisions of a national law, port practice or liner terms.

We also note that in the context of article 27, or of the new article proposed, the purpose of the expressions *loading* and *discharge* is to delineate the maximum possible scope of land transport liability regimes rather than the necessary limits of the maritime regime: the maritime liability regime might therefore extend to the period before loading or after discharge—for example, to storage or various barrowing operations, especially since these operations do not necessarily fall within the scope of land transport regimes.

New draft article 89, consolidating articles 27, 64 (2) and 89:

Article 89

International instruments governing other modes of transport

1. When a claim or dispute arises out of loss of, damage to or delay in goods, and the cause of such loss, damage or delay occurs during the carrier’s period of responsibility, but only before the time of their loading on to the ship or only after their discharge from the ship, the provisions of this Convention shall not prevail over the provisions of another international convention [or national law] which, at the time of such loss, damage or delay, apply mandatorily, according to their terms, to all or any of the carrier’s activities under the contract of carriage during that period;
2. [Notwithstanding paragraph 1, if the carrier cannot establish whether the goods were lost or damaged [or whether the delay in delivery was caused] during the sea carriage or during the carriage preceding or subsequent to the

sea carriage, the highest limit of liability in the international [and national] mandatory provisions that govern the different parts of the transport applies.]¹

3. Nothing contained in this Convention shall prevent the application of another international convention relating to a non-maritime mode of transport when that convention mandatorily governs multimodal transport.²

¹ Variant B of article 64 (2) (A/CN.9/WG.III/WP.56).

² Redrafted version of article 89 (A/CN.9/WG.III/WP.56): [Subject to article 92, nothing contained in this Convention prevents a Contracting State from applying any other international instrument which is already in force at the date of this Convention and that applies mandatorily to contracts of carriage of goods primarily by a mode of transport other than carriage by sea.]

T. Note by the Secretariat on the preparation of a draft convention on the carriage of goods [wholly or partly] [by sea] — Proposals by the International Road Transport Union (IRU) concerning articles 1 (7), 26 and 90 of the draft convention, submitted to the Working Group on Transport Law at its nineteenth session
(A/CN.9/WG.III/WP.90) [Original: English/French]

In preparation for the nineteenth session of Working Group III (Transport Law), the International Road Transport Union (IRU) submitted to the Secretariat the proposals attached hereto as an annex concerning articles 1 (7), 26 and 90 of the draft convention on the carriage of goods [wholly or partly] [by sea].

The document in the attached annex is reproduced in the form in which it was received by the Secretariat.

ANNEX

Proposals submitted by the International Road Transport Union (IRU) concerning articles 1 (7), 26 and 90 of the draft Convention the carriage of goods [wholly or partly] [by sea] (A/CN.9/WG.III/WP.81)

Article 1 (7)

1. The IRU shares the opinion expressed by the United States of America in the annex to their document A/CN.9/WG.III/WP.84, according to which a rail carrier should not be considered as a “maritime performing party”.

In addition to this opinion and for the same reasons as those pointed out by the US, the IRU proposes that the road carrier performing services within a port area should, like rail carriers, also not be considered as a “maritime performing party”. The text proposed by the US could be slightly amended to also integrate road carriers, thus reading as follows:

“A rail or road carrier, even if it performs services that are the carrier’s responsibilities after arrival of the goods at the port of loading or prior to the departure of the goods from the port of discharge, is a non-maritime performing party.”

Article 26

2. The IRU proposes to eliminate Variant B of subparagraph (a) of article 26 for the two following reasons:

- if “another international instrument” is imperatively applicable, this imperative application is hindered if it is subordinated to the condition that the shipper made or did not make a separate and direct contract with the carrier for the non-maritime part of the transport;

- upholding the condition that the shipper made or did not make a separate and direct contract with the carrier for the non-maritime part of the transport contradicts also subparagraph (c) of Article 26, according to which the imperative provisions of other such international instruments “cannot be departed from by contract either at all or to the detriment of the shipper”.

Article 90, subparagraph (b)

3. This provision, inspired by the provisions of Article 6 of the Hague Rules and the Hague-Visby Rules, has led to abuses by some maritime performing parties operating in the English Channel and the North Sea. According to these maritime performing parties, the containers or road vehicles — whose transport has become common in the past 50 years — are still considered as “non-ordinary shipments” for which the indemnity amounts to a maximum of SDR 666,67 per unit, the container or road vehicle being considered as a single unit. The fact that the transport document refers to a number of packages or a specific weight is considered, by these maritime performing parties, as not relevant. To avoid the extension of such abuses through the instrument now proposed by UNCITRAL, the IRU proposes to complete subparagraph (b) by adding at the end of the subparagraph the following words:

“The containers or road vehicles, whose transport is made by a ship entirely or partially equipped to undertake such transport, cannot be considered as “non-ordinary commercial shipments.”

**U. Note by the Secretariat on the preparation of a draft convention
on the carriage of goods [wholly or partly] [by sea] — Proposal of the
United States of America on carrier and shipper delay, submitted to the
Working Group on Transport Law at its nineteenth session
(A/CN.9/WG.III/WP.91) [Original: English]**

In preparation for the nineteenth session of Working Group III (Transport Law), the Government of the United States of America submitted to the Secretariat the proposal attached hereto as an annex with respect to carrier and shipper delay in the draft convention on the carriage of goods [wholly or partly] [by sea].

The document in the attached annex is reproduced in the form in which it was received by the Secretariat.

ANNEX

Proposal of the United States of America on carrier and shipper delay

I. INTRODUCTION

1. At the 13th session of the Working Group, a draft article providing for carrier liability for consequential damages resulting from delay was included in the draft convention (A/CN.9/552 at paragraphs 18-31). More than two years later, at the 18th session of the Working Group, a further provision imposing liability on shippers for consequential damages resulting from delay was included in the draft convention (A/CN.9/616 at paragraphs 83-113). When these provisions were considered, it was understood that liability caps for both carriers and shippers would eventually be stipulated.¹ As the provisions on carrier and shipper delay are necessarily related in order to ensure an overall fair balance in rights and obligations among relevant interests, it was unfortunate that these provisions were not simultaneously considered by the Working Group from the outset. It is widely recognized that the final text produced by the Working Group must be viewed as equitable and balanced to increase the likelihood of widespread acceptance and ratification.

2. A number of delegations did not concur with the approach of introducing liability for consequential damages arising from delay for either carriers or shippers, believing such a course would result in legal uncertainties, unnecessary costs, and severe difficulties in practical implementation. Moreover, those delegations anticipated it would prove impossible to determine suitable caps on this type of liability for either carriers or shippers.

¹ At the 18th session, there was a suggestion that the carrier liability cap for delay might be one times freight, and the shipper liability cap for delay might be 500,000 SDRs (approximately €570,000 Euros or U.S. \$751,500). These proposed caps are strongly opposed by shippers involved in the U.S. trades, as they are not perceived to be fair and equitable.

3. Although the United States was one of the countries strongly preferring no delay provisions in the draft convention, since the 13th session of the Working Group the U.S. delegation has engaged in extensive consultations within our Government, as well as with the academic community and industry, in order to develop a reasonable position on the appropriate liability caps to complement the regime proposed in the draft convention. We have not been able to find any caps that are acceptable to all of our major industry participants (shipper, carrier, and intermediary interests). Therefore, the United States continues to believe that it will be difficult, if not impossible, to establish caps on this type of liability that would be equitable and acceptable to interested parties. Moreover, the United States does not believe that including delay liability in the draft convention advances any legitimate public policy objective. Imposing delay damages will be practically unworkable, and it will be bad public policy.

4. The United States respectfully requests that other delegations consider the economic and policy arguments set forth in this paper. This type of analysis has not previously been presented to the Working Group. We hope that other delegations will, like the United States, come to the conclusion that liability for consequential damages caused by delay should not be included on a mandatory basis in the new convention.

5. Preliminarily, it may be useful to remind delegations of the very limited scope of the issue that is before us:

- Everyone agrees that physical loss caused by either shipper or carrier delay is covered by the draft convention. The question here is whether consequential, i.e., pure economic, loss should be covered, and, if so, what the liability caps should be.
- Everyone agrees that the shipper and carrier should be liable for consequential loss caused by delay if their contract so provides. The question here is whether there should be liability for consequential damages caused by delay if the goods do not arrive in a "reasonable" period of time, even if there is no delivery date in the contract.
- Everyone agrees that any delay liability rules included in the draft convention would not be mandatory for "volume contracts" covered by draft article 89's special rules.
- We are left with only two situations: (1) The carrier may be liable for consequential damages if it causes the vessel to be delayed, but only to shippers that prove that they were damaged as the result of the carrier-caused delay (e.g., the shipper's plant was forced to shut down for lack of a part); and (2) A shipper may be liable to the carrier for damages that the carrier incurs (e.g., loss of use of the vessel or additional port charges) as a result of the shipper-caused delay.

With these parameters in mind, we present the following analysis.

II. IMPOSING DELAY LIABILITY ON SHIPPERS AND CARRIERS IS AN UNNECESSARY CHANGE TO CURRENT LAWS AND COMMERCIAL PRACTICES IN MOST COUNTRIES.

6. As documented in A/CN.9/WG.III/WP.74, the most widely accepted legal conventions governing maritime shipping liability, the Hague and Hague-Visby

Rules, do not hold carriers or shippers liable for consequential damages resulting from delay. It appears that only the Hamburg Rules and the Scandinavian Maritime Code provide for such liability, and on carriers only. Thus, for most of the trading world, incorporation of delay liability into the draft convention would represent a dramatic change from the status quo, at the risk of introducing greater complexity and uncertainty into the draft convention.

7. With respect to carrier liability for delay, even in those jurisdictions that apply the Hamburg Rules or the Scandinavian Maritime Code, it is difficult to find instances in which claims have been pursued to recover delay damages from carriers. This suggests that such provisions have not proven effective in accomplishing their expressed purpose, or that there is no need in practice for the imposition of such liability.

8. Moreover, the lack of cases in which shippers have sought to recover delay damages from carriers in maritime transport, both in the few jurisdictions that expressly provide for such recoveries and in other countries, strongly suggests that this is an issue that as a practical matter tends to get resolved amicably between carriers and shippers.

9. With respect to shipper liability, the scenario in which a shipper is most likely to cause vessel delay is when it fails to provide accurate or complete shipment information to the carrier, the carrier reports such information to customs authorities under new security regulations, and a customs authority delays the vessel to ensure that the cargo loaded on the vessel is not a security threat or otherwise unlawful. Just as shippers appear to have made few or no delay claims against carriers, however, the United States is not aware of any delay claims made by carriers against shippers for this type of delay since the relevant security regulations were adopted in 2002.

10. Based on the relatively recent adoption of security rules and the lack of claims or cases involving vessel delays, we believe there are too many questions and uncertainties surrounding the issue of liability for delay. The United States does not believe it is wise to insert those uncertainties into the draft convention. These circumstances argue strongly against the radical change to current law that would result from the inclusion of delay in the draft convention, which is intended to modernize the liability regime by addressing real commercial issues involving maritime commerce.

11. Furthermore, the Working Group has not been presented with any factual evidence whatsoever that there is a need to include liability for delay in the draft convention. In light of the foregoing, the United States is not aware of any pressing need for governments to impose these new liabilities on shippers and carriers.

12. In this regard, many goods moving via ocean transport are relatively low value commodities (agricultural commodities, raw materials, paper, etc.). Even if the draft convention were to provide a basis for shippers to assert claims on account of delays, it is unlikely that shippers of such commodities would be in a position to prove that they sustained any consequential damages, and thus they would be unable to recover compensation for delay under the draft convention. As explained in section III below, however, if delay liability is included in the draft convention, all shippers will experience increased costs, with those costs disproportionately impacting shippers of goods that are not time-sensitive.

13. Moreover, other developments in the Working Group have had an effect on how delay should be treated in the draft convention. Recalling the Working Group's deliberations at its 13th session, a principal justification asserted for making a significant change to current law and providing for carrier liability for delay was that such action was thought to be necessary in light of the increasing prevalence of "just-in-time" inventory management techniques in global supply chains, whereby assured delivery of goods by an agreed date is an essential element of the transport undertaking. But at its 15th session, the Working Group decided to include draft article 95 on "volume contracts," which upholds the integrity of private shipping contracts. As explained in greater detail in section IV below, such contracts are a much more efficient means of addressing this issue, particularly for time-sensitive shipments, and, as a practical matter, virtually all shipments in "just-in-time" supply chains are transported pursuant to volume contracts of that nature. Thus, the need for protection against delay for "just-in-time" arrangements in this draft convention appears to have been overstated and the Working Group should not continue to pursue inclusion of delay without pausing to consider the implications of the subsequent decision to adopt draft article 95.

III. DELAY LIABILITY WILL LEAD TO UNNECESSARY COST INCREASES FOR SHIPPERS AND CARRIERS.

14. As noted above, imposing delay liability on shippers and carriers will add significant costs to the ocean transportation industry. Carriers facing exposure to this new liability will be required to purchase insurance to cover their potentially significant maximum exposure (e.g., perhaps one times freight on each container or other unit of cargo on the vessel) and will factor this cost into their freight rates. Shippers facing liability for delay can likewise be expected to purchase insurance cover in an amount equal to the cap on their liability for delay, also a significant maximum exposure (e.g., perhaps 500,000 SDRs per voyage). The end result is an increase in cost to all shippers in the form of higher freight rates due to the increased costs imposed on carriers, and their own increased insurance costs to protect against the liability risks created by the draft convention. These costs will be borne not only by shippers of high-value, time-sensitive commodities, but by many small- and medium-sized enterprises that are shipping lower value commodities and do not need protection against the consequences of shipping delays. This second category of shipper in effect will be required to subsidize the cost of providing such protection for others if liability for carrier delay is included in the draft convention. The shipper delay provisions will likewise add an extraordinary cost to the industry on a cumulative basis. In addition, the exposure created by the proposed shipper delay provisions could have a devastating effect on small businesses that fail to purchase insurance protection but cause a vessel delay due to a documentation or other error.

15. The cost increases described above could have a double impact on transportation intermediaries such as NVOCCs and forwarders, which provide much needed competition to the ocean carriers that otherwise would offer the only transport options in many trades. This is because intermediaries will be required to insure against liability for delay in their capacity as carrier, as well as against liability for delay in their capacity as shipper. These costs will necessarily be passed on to the customers of the intermediary, which are typically small- and medium-sized enterprises. Thus, inclusion of delay will not only again have a disproportionate impact on small- and medium-sized shippers, but will also make

intermediaries a less attractive option for all shippers because their cost of doing business will be so significantly increased.

16. Moreover, most businesses that rely on “just-in-time” inventory management have put in place business interruption insurance, which compensates them for losses of this nature whether due to ocean transportation delays or other factors. This approach, because it is specifically tailored to the needs and business model of the individual shipper or carrier, is a far more efficient and economical means of risk management than the “one size fits all” approach reflected in the current draft of the draft convention.

IV. DELAY LIABILITY SHOULD NOT BE IMPOSED ON ALL SHIPPERS AND CARRIERS BUT SHOULD BE ADDRESSED IN PRIVATE CONTRACTS BETWEEN PARTIES THAT NEED SUCH PROTECTION.

17. The United States notes that the Working Group, at its 15th session, decided to incorporate in draft article 95 a regime applicable to “volume contracts” that upholds the integrity of private shipping contracts that derogate from the otherwise applicable terms of the draft convention subject to the limitations provided in that article. Virtually all cargo moving in “just-in-time” supply chains is (and will continue to be) transported pursuant to such volume contracts, which reflect appropriate delivery time commitments and penalties, as agreed between the shipper and carrier or intermediary in question. Simply put, carriers and shippers both are free to negotiate and agree upon contract terms relating to carrier delivery requirements or cargo documentation requirements, including the consequences that will occur in cases of late deliveries or vessel delays.

18. It would be more efficient and equitable to leave the issue of delay to contractual arrangements between those parties who want and need protection such that they may negotiate appropriate terms based on their specific factual circumstances. It would be far more preferable to have contracting parties make appropriate transportation and risk management decisions based on their specific circumstances and shipping arrangements, than to impose a system of delay liability and the resulting costs on all carriers and shippers, many of which have no need or desire for such protection.

V. INCLUDING DELAY LIABILITY IN THE CONVENTION WILL HAVE SIGNIFICANT NEGATIVE IMPLICATIONS FOR ALL CONCERNED PARTIES.

19. At present, carriers typically do not guarantee that goods will arrive on any specific date or even within a prescribed time window, as a number of operational factors may arise that could cause deviations from the usual timeline. Parties doing business in the ocean shipping environment fully understand and accept these inherent uncertainties of this form of transport. In cases in which a shipper cannot tolerate an uncertain delivery date, the goods are normally transported pursuant to a volume contract whereby a time-definite delivery commitment has been negotiated and is reflected in the freight rate. Alternatively, many such time-sensitive goods are not sent by sea at all, but are transported instead by air freight.

20. If the draft convention were to include new provisions imposing liability for delay, a number of unfortunate consequences will likely ensue. As explained above, because the ocean shipping industry does not at present generally operate on the basis of exact delivery dates, it could prove difficult and would introduce much

uncertainty to attempt to discern at what point a delay is significant enough to trigger legal liability to pay damages. The draft convention takes the approach of applying a reasonableness standard to resolve this question. This, of course, really just defers the issue until an actual claim arises, at which point both the carrier and the shipper will likely find it necessary to incur substantial expenses litigating their respective positions on the question. Moreover, it seems inevitable that different courts in different jurisdictions may reach different results as to what constitutes reasonableness, thus resulting in inconsistent treatment of similarly situated claimants, and a lack of certainty and predictability for shippers, carriers, and their insurers going forward. Insurers may understandably have to assume they may face exposure under a “worst case” scenario — i.e., the highest liability under the most extreme interpretation of reasonableness adopted by any forum anywhere in the world — even though the probability of a claimant actually recovering damages of that magnitude may be low.

21. Faced with potential delay liability, carriers can be expected to protect themselves by altering their published schedules and transit times to increase delivery times. This inevitable expansion of transit times would make projected deliveries less rather than more certain, and could needlessly lengthen shippers' supply chains and thereby create inefficiencies. The risk of shipper liability for delay created by the draft convention could compound those inefficiencies if shippers are forced to alter their documentation processes and information flows in order to provide shipment information to carriers earlier than is already required under existing security laws (generally 24 hours before loading) out of fear of inadvertently causing a vessel delay. These adverse consequences are the exact opposite of the purpose for which delay liability is proposed to be included in the draft convention.

22. Moreover, under a new regime imposing liability for delay damages, ocean carriers may be less willing to undertake to arrange inland transportation, since they would find it untenable to be held potentially liable for delays caused by the inland carriers, and for delays resulting from missed connections between the inland transportation and the ocean voyage. This would only add to the cost and complexity of international shipping, particularly for small- and medium-sized businesses, and would tend to narrow the access to world markets for otherwise competitive producers. Such an outcome plainly is contrary to fundamental economic interests of all concerned, and to the over-arching objectives of the exercise with which this Working Group is tasked.

23. The United States believes that the intense competition that characterizes the ocean shipping industry, the potential loss of business by carriers that fail to perform as advertised, and the economic consequences to a carrier of failing to adhere to its schedule (having to speed up vessels thus increasing fuel costs, using alternate and more expensive means of transport, skipping ports of call, port and terminal congestion and the like) all provide a major incentive for carriers to perform in a timely fashion. In addition, shippers likewise have strong commercial incentives to provide carriers with accurate and complete information in order to ensure that their cargo gets loaded onto the vessel and delivered in time to meet their customers' or their own business requirements. Furthermore, if a shipper fails to provide accurate and complete cargo information to a carrier and that failure causes a breach of security regulations, the shipper is already exposed to potential liability outside of the Convention. Thus, there are significant commercial and legal

incentives already in place that will cause shippers to exercise due care to avoid causing delays.

VI. CAPS ON LIABILITY DO NOT ADDRESS THE FUNDAMENTAL PROBLEMS WITH DELAY DAMAGES.

24. The current draft provisions contemplate that there will be caps on the amount of carrier and shipper liability for consequential delay damages. As noted in the report on the 18th session (A/CN.9/616 at paragraph 105), it was suggested that the caps might be in the range of one times the freight with regard to carrier liability, and 500,000 Special Drawing Rights (SDRs) with regard to shipper liability. The United States strongly believes that caps on delay liability do not address the broader problems resulting from the inclusion of delay in the draft convention.

25. As noted above, the inclusion of delay requires both carriers and shippers to insure against their respective risks. The cost of insurance will be passed on to shippers by carriers, resulting in higher freight rates. This increases shippers' costs, which will be further increased by the cost of insuring against their own potential delay liability. As further noted above, many shippers do not need this protection and should not be forced to pay for it. Moreover, caps on liability only serve to make the risk reasonably insurable, and do not remedy the fact that including delay liability in the draft convention imposes additional costs on all participants and will create inefficiencies in the ocean transportation industry that are unwarranted.

26. Moreover, resolving the issue of consequential damages for delay in a manner that will be viewed as fair and equitable by the industry is essential to ensuring broad acceptance of the draft convention and widespread ratification. The United States believes that including delay liability in the draft convention for both carriers and shippers is a mistake for all of the public policy and commercial reasons stated above.

VII. POSSIBLE COMPROMISE

27. For all of the above reasons, the United States believes that including delay liability in the draft convention would hurt, not help, all of the affected commercial interests (except, perhaps, the insurers), as well as consumers. If the Working Group nevertheless decides to retain delay liability, then it is essential that language be included making such liability optional in all contracts.

28. At its 18th session, the Working Group decided (A/CN.9/616, at paragraph 113) that text should be prepared that would make shipper's delay liability subject to freedom of contract, just as there is bracketed "unless otherwise agreed" language in the provision on carrier's liability for delay (draft article 63 in A/CN.WG.III/WP.81). Thus, the Working Group has recognized that the issue of whether shipper and carrier delay liability should be optional in all contracts is an open issue that has not yet been decided. The recently submitted Swedish proposal (A/CN.9/WG.III/WP.85) addresses all other parts of the Working Group's conclusions on shipper's delay liability, but does not address the freedom of contract aspect.

29. If delay is included in the draft convention, the United States believes that language must be included that would make these provisions subject to freedom of contract. Unfortunately, however, simply including "unless otherwise agreed" in the articles on shipper and carrier delay liability would not work. This is because in

most non-volume contracts (which are all that need concern us here as it has already been agreed that volume contracts can derogate from the draft convention's delay rules), the shipper may have little or no real opportunity to object to any of the contractual terms, and, in fact, might not even see the contract until after the goods have been delivered. Thus, if the language in the draft convention on both shipper and carrier delay liability simply states that the draft convention's rules apply "unless otherwise agreed," the carrier theoretically could delete all delay liability for itself, while leaving in (and even increasing) delay liability for the shipper. In order to avoid this inequitable result, the draft convention should include an "all or nothing" rule on delay liability. In other words, the parties should have two, and only two, choices: either be silent in the contract on the delay issue, in which case the draft convention's rules apply; or, state in the contract that the draft convention's delay liability rules for both carrier and shipper do not apply. Such a provision could read as follows:

"Any contract to which this Convention applies may provide that there is no liability under the contract for economic loss caused by delay, notwithstanding the provisions of Articles 30 and 63."

VIII. CONCLUSION

30. The Working Group has benefited from the breadth of views contributed by the wide range of Member States and Observers participating in this process, each of which has its own unique perspective and interests in regard to maritime shipping. One fundamental point that has become very clear is that the end product of our collective efforts must reflect a fair balance among the relevant stakeholders, and a fair and equitable distribution of risks and liabilities. On the issue of liability for consequential damages for delay, the United States is very concerned that it will be difficult, if not impossible, to find caps that will be accepted as fair and equitable by our shipper and carrier interests..

31. A convention of broad applicability such as this draft convention necessarily must propose "one size fits all" solutions. In the case of delay damages, however, the truth of the matter is that "one size fits no one." Not only is there no factual evidence supporting a need to address delay in the draft convention, but the inclusion of delay is being pursued with no analysis of or appreciation for the potential consequences that will result. The United States believes that the introduction of this novel form of liability could have far-reaching consequences on international trade, including a negative impact on the availability of affordable ocean transportation service and the competitiveness of certain commodities, particularly those of relatively low value.

32. The Working Group is in the final stages of a truly historic endeavour, which all of us hope will lead to a widely-adopted maritime liability regime to replace the patchwork quilt of arrangements that currently exists. This exercise has resulted in a lengthy and complicated draft convention. The current draft actually contains more articles than the Hague Convention, the Hague Convention as amended by the Visby Protocol, and the Hamburg Rules added together. To attempt to introduce this new liability for carrier and shipper consequential delay damages will add further layers of needless complexity.

33. If the Working Group nevertheless decides to include carrier and shipper consequential delay damages in the draft convention, despite what the United States believes is overwhelming evidence that this will most likely harm, not help, all

parties except insurers, it should do so on a non-mandatory basis. (The question of whether the delay issue should be subject to freedom of contract in all cases has been “on the table” since the beginning of these negotiations, and has not yet been decided. See para. 29, above.) Otherwise, we fear that the delay issue could jeopardize the broad support and acceptance that this draft convention needs in order to be successful.

**V. Note by the Secretariat on the preparation of a draft convention
on the carriage of goods [wholly or partly] [by sea] — Joint proposal
by Australia and France on freedom of contract under volume
contracts, submitted to the Commission at its thirty-ninth session
(A/CN.9/612) [Original: English]**

In preparation for the thirty-ninth session of the Commission, the delegations of Australia and France submitted to the Secretariat the document attached hereto as an annex containing a joint proposal on freedom of contract under volume contracts in the draft convention on the carriage of goods [wholly or partly] [by sea] being considered in Working Group III (Transport Law). The text is reproduced as an annex to this note in the form in which it was received by the Secretariat.

ANNEX

Introduction

1. The draft version of article 95 on special rules for volume contracts was examined at the seventeenth session of Working Group III. Few changes were made during that session to the version of the article proposed to the Working Group. Several delegations nevertheless voiced concerns about the extent of freedom of contract allowed under volume contracts. The European Shippers Council, commenting for the first time at the Working Group, also pointed to difficulties that the current version of the draft text could raise.
2. It should also be stressed that the draft instrument initially submitted to the Working Group did not contain any general provisions favourable to freedom of contract.¹ The draft version of article 95 reflected a clear change in the direction of the Working Group's work, because it was only introduced during the fifteenth session of the Working Group, when the instrument had already been substantially drafted.
3. Australia and France therefore consider that further debate is required on this important issue. They would like to draw the Commission's attention in a plenary session to the issue of freedom of contract in the draft instrument and submit alternative proposals.

Historical context

4. The history of the law of carriage of goods by sea is the history of the gradual introduction of mandatory rules on liability. By the late nineteenth century, freedom

¹ Document A/CN.9/WG.III/WP.32, the initial version of the draft convention, clearly stated that "any contractual stipulation that derogates from this instrument is null and void, if and to the extent it is intended or has to its effect, directly or indirectly, to exclude, [or] limit [, or increase] the liability for breach of any obligation of the carrier, a performing party, the shipper, the controlling party, or the consignee [...]."

of contract was being used extensively and aggressively by ship-owners to unfairly reduce their liabilities for cargo loss or damage. To combat such practice, in 1893 the United States introduced the Harter Act, a mandatory regime governing trade with the country. This was followed in 1924 with the signing of the International Convention for the Unification of Certain Rules of Law Relating to Bills of Lading, which now forms the foundation of the law on carriage of goods by sea. That Convention states that “any clause, covenant, or agreement in a contract of carriage relieving the carrier or the ship from liability for loss or damage to, or in connexion with, goods arising from negligence, fault, or failure in the duties and obligations provided in this Article or lessening such liability [...], shall be null and void and of no effect”.

5. This mandatory regime of liability is found today, in highly comparable terms, in the international conventions on the different modes of carriage.² Consequently, as it stands, the instrument currently being drafted is the only one to contain provisions that offer considerable scope to freedom of contract.

6. The shift, through the mechanism of volume contracts, from a fundamentally mandatory regime to a largely derogative regime represents a major change. The risk is that in some States obstacles may arise to ratification of a convention whose provisions, which differ sharply from national legislation in the field, appear to be incompatible with fundamental principles of domestic law.

Analysis of the current provisions on freedom of contract

7. The definition of a volume contract given in article 1 of the draft instrument could cover a wide range of contracts of carriage. Indeed, the new version adopted on a proposal from the Finnish delegation, clearly states that “a volume contract is a contract of carriage”.³ This definition of a volume contract is distinguished by its lack of limitation, whether in terms of the duration of the two parties’ commitment, the number of shipments or the quantities carried. A volume contract could therefore potentially cover almost all carriage of goods by shipping lines falling within the scope of the convention. This is likely to leave a loophole in the convention that would enable the parties to release themselves from the binding provisions of the instrument. For example, it is quite conceivable, from a legal point of view, that the carriage of two containers over a period of one year could be governed by a volume contract.

² The Convention on the Contract for the International Carriage of Goods by Road (CMR) stipulates that: “any stipulation which would directly or indirectly derogate from the provisions of this Convention shall be null and void” (Art. 41.1). Similarly, the Montreal Convention of 1999 on air carrier liability, states that “any provision tending to relieve the carrier of liability or to fix a lower limit than that which is laid down in this Convention shall be null and void” (Art. 26). On the carriage of goods by inland waterways, the Budapest Convention of 2001 (which came into force in 2005) also states that “any contractual stipulation intended to exclude, limit or increase the liability, within the meaning of this Convention, of the carrier, the actual carrier or their servants or agents, shift the burden of proof or reduce the periods for claims or limitations [...] shall be null and void. Any stipulation assigning a benefit of insurance of the goods in favour of the carrier is also null and void.”

³ The draft version of article 1 (b) sets forth: “‘Volume contract’ means a contract that provides for the carriage of a specified quantity of cargos in a series of shipments during an agreed period of time. The specification of the quantity may include a minimum, a maximum or a certain range.”

8. With respect to the “special rules for volume contracts” set forth in article 95, which are designed to introduce freedom of contract into this framework, the conditions established for the article’s application appear equally devoid of limitation.

9. First, regarding the conditions of form for derogations from the convention, it is only stipulated that the volume contract “is individually negotiated or prominently specifies the sections [...] that contain derogations” (art. 95.1 (a) and (b)). More precisely, the conditions indicated do not require that both parties to the contract expressly consent to the derogations: this clearly opens up the possibility that *standard contracts* containing derogating clauses could be submitted to the shippers. The principle of freedom of contract should, however, be based on genuine negotiation between the shipper and the carrier. If volume contracts are to be the basis of wide-ranging derogations from the terms of the draft conventions, it is imperative that those volume contracts be genuinely negotiated between the parties.

10. Secondly, regarding the scope of the authorized derogations, the limits set on the carrier’s right to derogate from the Convention seem extremely weak. It appears paradoxical that the right to derogate from the Convention is established as a principle (art. 95.1).⁴ The only exclusions from this right, set forth in paragraph 4, are the carrier’s obligation to keep the ship seaworthy and properly man the ship (art. 16.1), and the loss of the right to limit liability (art. 66). Furthermore, these limits do not appear to have been set in the interests of the shipper, but to have been designed as minimal obligations with respect to public interest, given the risks associated with an unseaworthy vessel in particular.

11. Australia and France contend that the public interest defended by other provisions of the convention comprises a minimal level of protection for the contracting parties and that the draft texts on freedom of contract should be revised accordingly.

Proposals regarding volume contracts

12. It would be preferable to clarify the definition of “volume contract” given in draft article 1 (b) as follows (the proposed amendments appear in bold type):

“‘Volume contract’ means a contract that provides for the carriage of a **set** quantity of cargo in a series of shipments during a **set** period of time **of no less than one year**. The **set** quantity may be a minimum, a maximum or a certain range.”

13. It would be desirable for the derogations from the provisions of the instrument to be subject to express agreement by the two parties. In article 95.1 (a) we propose making the conditions of form cumulative by replacing “or” by “and” and, in (b), “clear” by “in highly visible type”. This will provide a much stronger safeguard against misuse of the right of derogation than merely allowing a situation in which a standard form contract with a derogation noted in the text can be used to satisfy the requirements of 95.1 (as could be the case with the draft of art. 95 contained in both A/CN.9/WG.III/WP.56 and A/CN.9/WG.III/WP.61).

⁴ The draft version of article 95.1 states: “[...] the volume contract may provide for greater or lesser duties, rights and obligations and liabilities than those set forth in the Convention [...].”

14. We propose not allowing any derogation from the liability regime set in the Convention, which is the core of the draft instrument, or from the fundamental obligations of the carrier and the shipper.

Thus, Australia and France suggest that paragraph 4 of article 95 could read as follows:

“Paragraph 1 does not apply to:

“(a) article 17 (basis of the carrier’s liability), or to article 66 (right to limit liability);

“(b) article 31 (basis of the shipper’s liability);

“(c) chapter 5 (obligations of the carrier); or

“(d) articles 28 to 30, and 33 (obligations of the shipper).”

15. Alternatively, a more concise version of the entire article 95 could read as follows:

“1. The parties to a volume contract may derogate from the provisions of this convention only if :

“(a) the volume contract is individually negotiated;

“(b) the derogation is agreed in writing between the parties; and

“(c) the derogation is set forth in highly visible type in the volume contract in a manner that identifies the clauses of the volume contract containing derogations.

“2. Any such derogation is not binding on third parties, unless those third parties accept it expressly.

“3. Any derogation made pursuant to paragraph 1 does not apply to the basis of the liability of the carrier or the shipper, as set forth in articles 17 and 31 respectively, nor to the fundamental obligations of the carrier or the shipper, as set forth in chapter 5 and in articles 28 to 30, and 33 respectively, and any derogation is null and void to the extent that it purports to so apply.”

V. INSOLVENCY LAW

A. Report of the Working Group on Insolvency Law on the work of its thirty-first session (Vienna, 11-15 December 2006)

(A/CN.9/618) [Original: English]

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Introduction

1. At its thirty-ninth session, in 2006, the Commission agreed that the topic of the treatment of corporate groups in insolvency was sufficiently developed for referral to Working Group V (Insolvency Law) for consideration in 2006 and that the Working Group should be given the flexibility to make appropriate recommendations to the Commission regarding the scope of its future work and the form it should take, depending upon the substance of the proposed solutions to the problems the Working Group would identify under that topic.

2. Working Group V (Insolvency Law), which was composed of all States members of the Commission, held its thirty-first session in Vienna from 11 to 15 December 2006. The session was attended by representatives of the following States members of the Working Group: Algeria, Argentina, Australia, Belarus, Canada, China, Colombia, Croatia, Czech Republic, Ecuador, France, Germany, Iran (Islamic Republic of), Italy, Lithuania, Mexico, Pakistan, Republic of Korea, Russian Federation, Singapore, Spain, Switzerland, Thailand, Tunisia, Turkey, Uganda, United Kingdom of Great Britain and Northern Ireland and United States of America.

3. The session was also attended by observers from the following States: Congo, Denmark, Dominican Republic, Ireland, Latvia, Libyan Arab Jamahiriya, Malaysia, Netherlands, Philippines and Slovakia.

4. The session was also attended by observers from the following international organizations:

(a) Organizations of the United Nations System: International Monetary Fund (IMF), and the World Bank;

(b) Intergovernmental organizations: Asian Development Bank (ADB), European Bank for Reconstruction and Development (EBRD), European Commission (EC), and Organization for Economic Cooperation and Development (OECD);

(c) International non-governmental organizations invited by the Working Group: American Bar Association (ABA), American Bar Foundation (ABFN), Center for International Legal Studies (CILS), Groupe de réflexion sur l'insolvabilité et sa prévention (GRIP 21), INSOL International, International Bar Association (IBA), International Insolvency Institute (III), and International Working Group on European Insolvency Law.

5. The Working Group elected the following officers:

Chairman: Mr. Wisit Wisitsora-At (Thailand)

Rapporteur: Ms. Jasna Garašić (Croatia)

6. The Working Group had before it the following documents:

(a) Annotated provisional agenda (A/CN.9/WG.V/WP.73);

(b) A note by the secretariat on the treatment of corporate groups in insolvency (A/CN.9/WG.V/WP.74 and Add.1 and 2).

7. The Working Group adopted the following agenda:

1. Opening of the session;

2. Election of officers;
3. Adoption of the agenda;
4. Consideration of the treatment of corporate groups in insolvency;
5. Other business;
6. Adoption of the report.

I. Deliberations and decisions

8. The Working Group began discussion of the treatment of corporate groups in insolvency on the basis of documents A/CN.9/WG.V/WP.74 and Add.1 and 2, and other documents referred therein. The deliberations and decisions of the Working Group on this topic are reflected in section II below.

II. Consideration of the treatment of corporate groups in insolvency

9. As a preface to discussion in the Working Group, it was noted that documents A/CN.9/WG.V/WP.74, and addenda 1 and 2, discussed the treatment of corporate groups in insolvency on the basis of the relevant recommendations contained in the UNCITRAL Legislative Guide on Insolvency Law (the Legislative Guide) and parts of the UNCITRAL Model Law on Cross-Border Insolvency (the Model Law). It was suggested that those texts should constitute the starting point for the discussions of the Working Group. It was also suggested that the Glossary contained in document A/CN.9/WG.V/WP.74 might be revised in the future in line with the progress of work, so as to provide uniform reference terminology for the Working Group.

A. Introduction

10. Delegations were invited to provide additional information on the treatment of corporate groups in insolvency that might complement the information made available to the Working Group.

11. It was indicated that the structure of corporate groups could vary greatly and be especially intricate, in particular, in the case of transnational corporate groups. Recent developments added further elements of complexity, for instance, in case of special forms of intra-group control, such as special purpose entities and joint ventures, as well as in the case of agreements for the temporary control of one company over another. It was added that economic activities, which were traditionally subject to a separate discipline, such as banking and insurance, were also increasingly performed in the context of corporate groups, thus adding an additional layer of complexity to their discipline.

12. It was confirmed that, while most jurisdictions refrained from offering a general definition of corporate groups, such definition often existed for special purposes, such as tax and accounting rules. In the insolvency field, the “separate entities approach” was prevalent, but certain instruments were available, under given conditions, to trigger the cross-liability of the companies belonging to the same corporate group.

13. In some jurisdictions that had recently reformed or attempted to reform their insolvency law to recognize the notion of corporate groups, it was observed that difficulties were encountered in the definition of that notion because of the need to achieve a balance between ensuring predictability and transparency and reflecting economic reality. It was suggested that reference to the notion of ownership, typically in terms of percentage of shares owned by the parent company, would provide a more certain basis for the definition of corporate groups. On the other hand, reference to the notion of control, while based on less objective parameters, would give more flexibility in addressing the diverse economic realities expressed by the operations of corporate groups.

14. The view was expressed that corporations served many important social, commercial and legal purposes. The provision of limited liability, in particular, facilitated the raising capital for business purposes, enabled creditors to rely on the assets and liabilities of the corporate entity with which they dealt, and provided certainty in commercial relations. It was noted that those purposes were baseline commercial and legal principles in many nations, and that to interrupt reliance and the expectations that arose from those principles would require some extraordinary rationale. It was further suggested that the circumstances for disregarding those principles rarely occurred.

B. Domestic issues

1. Application for commencement of insolvency proceedings

15. The Working Group considered how the provisions of the Legislative Guide with respect to commencement of insolvency proceedings might apply in the context of corporate groups and the changes, if any, that might be required with respect to the applicable commencement standard, the debtors against whom proceedings could be commenced and the parties who might make an application to commence.

16. As a starting point, the Working Group considered the position of an insolvent parent and an insolvent subsidiary and the question of whether or not an application could be made in respect of both debtors, referred to as a joint application. Although there were examples of laws that would permit such an application to be made, the general practice was for parallel applications to be made, in some cases at the same time, with various possibilities for treating the applications together for administrative purposes.

17. A second example involved the question of whether a joint application could be made with respect to an insolvent parent and a solvent subsidiary. Under some laws, a joint application could be made in respect of more than one member of a corporate group if only one member of the group was insolvent, provided that that insolvency had the potential to affect other members of the group; other examples were given where the insolvency of the parent could affect the solvent subsidiary because they were closely economically integrated, there was intermingling of assets or a specified degree of control or ownership. A different view emphasized the need to protect solvent members of a group and ensure their viability, notwithstanding the insolvency of the parent, as well as the need to protect the interests of creditors (including intra-group creditors), particularly those of solvent group members and ensure predictability for all creditors of members of a group with respect to the commencement of insolvency proceedings.

18. Reference was made to recommendations 15 and 16 of the Legislative Guide, which established the commencement standards for debtor and creditor applications respectively and formed the basis upon which an application could be made in respect of each member of a group that satisfied the standard, including imminent insolvency in the case of a debtor application. The reference to the debtor in recommendation 15 might be interpreted to include more than one member of a group in the same application. To some extent recommendation 15 could also cover the example of the insolvent parent and the solvent subsidiary, where the insolvency of the parent affected the financial stability of the subsidiary and it was likely to become insolvent following the insolvency of the parent (i.e. imminent insolvency). It was also suggested that if certain members of the group were left out of a debtor application under recommendation 15, it was always possible that they might subsequently be the subject of an application by creditors under recommendation 16.

19. Where recommendation 15 did not apply to both the parent and the subsidiary, however, it was suggested that the issue for consideration was whether there was any need to provide an exception that would allow the solvent subsidiary to be included in the insolvency of the parent and if so, what would be the basis of that exception. One view was that recommendation 15 (a) was sufficient and only those members of a group that could satisfy the insolvency test should be the subject of an application for commencement of insolvency proceedings. A different view was that a general concept of insolvency for groups might usefully be developed that would enable the financial status of the group as a whole to be considered and would resolve any difficulties that might be encountered by creditors seeking to commence insolvency proceedings against different members of a group. A further view was that recommendation 15 was not sufficient and that a more flexible test was required to ensure timely commencement of insolvency proceedings that might involve a solvent subsidiary in the insolvency of a parent in certain circumstances.

20. It was suggested that those circumstances might include the ones set forth in A/CN.9/WG.V/WP.74/Add.1, paragraph 12, such as intermingling of assets, unity of the group as a whole or consent of the parties. It was also suggested that, with respect to a debtor application, the debtor might be in a position to determine which members of the group should be included in the application; this would not apply in the case of a creditor application.

21. It was indicated that the treatment in the Legislative Guide of applications by a regulatory or other governmental body for commencement of insolvency proceedings should apply also in the case of corporate group insolvency.

22. A question was raised with respect to the possibility of a parent company applying for the commencement of insolvency proceedings against a subsidiary.

23. The general view was that that would be possible in certain cases, such as where the parent and the subsidiary shared the same representative and when the parent company was a creditor of the subsidiary and therefore able to apply as such. However, it was suggested that the adequate treatment of corporate groups in insolvency proceedings demanded further consideration of the matter. It was pointed out that when a group started to fail it might not be possible to distinguish solvent members from insolvent members, since in most cases all members of a corporate group would eventually be involved in insolvency proceedings. Moreover, the corporate group might have an interest in protecting the assets of solvent members in the context of a comprehensive reorganization plan. In considering the answer to

the question, it was further suggested that a careful balance should be sought between the different stakeholders, including creditors of the solvent member and shareholders that were not members of the corporate group.

24. It was suggested that different recommendations might need to be made with respect to reorganization and liquidation proceedings. In particular, it might be desirable to recognize the wish of the parent company to have a comprehensive reorganization plan involving all the members in the group. After discussion, there was no consensus on the need for an exception to recommendations 15 and 16 of the Legislative Guide to permit application by a parent company in respect of a subsidiary.

2. Effects of commencement

(a) Appointment of a single insolvency representative

25. The view was expressed that the appointment of a single insolvency representative to proceedings in respect of more than one member of a corporate group would be desirable since it would ensure coordination of the administration of the various members, reduce related costs and facilitate the gathering of information on the corporate group as a whole. However, it was noted that the appointment of a single administrator might give rise to conflicts of interests, and that simplification of the structure of the administration should not be sought to the detriment of any of the interests involved.

26. The general view was that in a number of cases, especially in the context of corporate group reorganization, the appointment of a single administrator would be desirable, but that provision should be made for the appointment of separate administrators or co-administrators for each member of the group where conflicts of interest might arise.

(b) Cases where management remains in office after commencement

27. It was noted that the provisions of the Legislative Guide that allowed the management to remain in office after the commencement of insolvency proceedings would find application also in the case of insolvency of corporate groups.

(c) Application of the stay to a solvent corporate group member

28. The view was expressed that recommendations 39 to 51 of the Legislative Guide on the effects of commencement and, in particular, application of a stay, could apply in the case of the insolvency of one or more members of a corporate group to those members against which insolvency proceedings were commenced.

29. A question was raised with respect to the possibility of extending the application of those recommendations to solvent members of that corporate group, in the event that not all members were subject to insolvency proceedings.

30. It was suggested that in some jurisdictions that extension, with particular regard to the effects of a stay or suspension, would be possible, and that that possibility was reflected in recommendation 48 of the Legislative Guide. While further consideration might be given to the protection of creditors of the solvent members, it was suggested that adequate protection for those creditors might be found in the relevant provisions of the Legislative Guide. In particular, it was suggested that recommendation 51 might have some application beyond secured

creditors in such circumstances. A different view was that in other jurisdictions the extension of the effects of a stay or suspension to solvent members might not be possible, as in some cases it might conflict with the protection of property rights, at both the constitutional and international level. Additionally, it was suggested that certain jurisdictions might have difficulties in granting insolvency-related relief, such as a stay or suspension, against a solvent member. However, effects similar to those of a stay might be obtained in those jurisdictions by requesting a provisional measure in conjunction with the commencement of insolvency proceedings against other members of that corporate group.

31. After discussion, there was agreement that the effects of a stay should not be automatically extended to solvent members of a corporate group. However, it was also the view that in certain cases, for example to protect an intra-group guarantee, such extension could be available at the courts' discretion and subject to certain specific conditions.

(d) Joint administration

32. The Working Group considered the possibility of joint administration of proceedings commenced against one or more members of a corporate group. Although jurisdiction was generally determined by reference to the location of each member of a group, joint administration was possible as a matter of practice in a number of jurisdictions to facilitate efficient administration. Some of the problems that might be raised by joint administration were considered and it was pointed out, for example, that issues could arise, even in a domestic context, where the parent and subsidiary were located in different places and different courts were competent to consider the respective insolvency applications. Creditors of the different members of a group might also be located in different places, raising issues of representation and location of creditor committees. In some States, different proceedings could be consolidated or transferred to an appropriate court. In one example, that appropriate court might be the court with competence to administer insolvency proceedings against the parent of a group.

(e) Use and disposal of assets

33. The question of whether the assets of a solvent member of a group could be used to fund the ongoing operations of an insolvent member, pending resolution of the insolvency proceedings, was raised. Reference was made to recommendation 54 of the Legislative Guide, which addressed the use of third party owned assets in the possession of the debtor. It was suggested that while that recommendation might cover some issues involving the use of the assets of one group member by another group member, the issue in the group context was potentially broader and would involve use of assets not in the possession of the debtor. The general view expressed was that such use of assets could not be supported unless the owner of those assets, the solvent member, could be included in the insolvency proceedings. Such support might raise questions of avoidance, particularly where the supporting member subsequently became insolvent, and also raised concerns for creditors of the supporting member.

(f) Post-commencement finance

34. The question with respect to post-commencement finance was related to the question on use and disposal of assets: could the assets of a solvent member of

a group be used to obtain financing for an insolvent member from an external source or to fund the insolvent member directly and, if so, what were the implications for the recommendations of the Legislative Guide concerning priority and security. For example, would a solvent subsidiary be entitled to priority under recommendation 64 if it were to provide funding to its insolvent parent or would that transaction be subject to subordination as intra-group lending? It was observed that while post-commencement finance was important in the context of individual proceedings, as noted in the Legislative Guide, it was even more critical in the group context; if there were no ongoing funds there was very little prospect of reorganizing an insolvent group. Notwithstanding that importance, the view was expressed that using group assets to obtain financing was possible where all members of the group were insolvent; this would be covered by the recommendations of the Legislative Guide. Difficulties arose, however, where it was suggested that the assets of a solvent member be used to fund an insolvent member or as the basis for obtaining external funding. The general view expressed was that that should not be permitted, although it was acknowledged that there might be situations where such funding could be provided if the creditors of the solvent member consented.

3. Reorganization of two or more members of a group

35. The Working Group considered whether it would be possible for an insolvent group to be reorganized through a single plan. While several insolvency laws permitted the negotiation of a single plan, under others it was only possible as a matter of practice if different insolvency proceedings against group members could be coordinated. A further approach enabled a single plan to be negotiated through procedural consolidation of all proceedings against group members. It was noted that proceeding by way of a single plan had the potential to ensure savings across the group's insolvency proceedings. With respect to voting on and approval of a plan, different approaches were taken. Under one approach, the different interests of corporate group members and their creditors could be grouped in classes and voting requirements, in terms of majorities within classes and of classes would remain the same as in proceedings for approval of a plan for a single debtor. Another approach provided for a unified plan with different majority requirements designed to facilitate approval. The consequences of failure to approve such a unified plan was liquidation of all insolvent members of the group covered by the plan. After discussion, it was agreed that there would be benefit in permitting a single reorganization plan to be negotiated, subject to the same requirements for approval and to the same protections as included in the Legislative Guide.

4. Remedies

(a) Consolidation

36. The Working Group noted that the remedies discussed in A/CN.9/WG.V/WP.74/Add.1, paragraphs 24 to 45 (extension of liability, contribution orders and substantive consolidation or pooling) could essentially be divided into those that required a finding of fault and those that relied upon the establishment of certain facts with respect to the operations of the corporate group. It was suggested that in the case of misfeasance of management of a debtor other more appropriate remedies might be available, including removal of management or allowing creditors, as opposed to the debtor, to prepare a reorganization plan.

37. It was noted that the remedies discussed in paragraphs 24 to 45 were available in only limited circumstances and were rarely used as they had the potential to disrupt certain fundamental principles relating to a corporate entity, that is, limited liability and the ability of creditors to rely on the corporate entity (and the rights, duties and obligations that attach to it). The view was expressed that the Working Group should not try to establish a standard for when those fundamental principles would be interrupted as the grounds for doing so, if at all, would be fact-intensive and vary depending upon legal cultures and legal systems. It was added that increasing the recovery of some creditors was an insufficient ground in and of itself for interrupting those fundamental principles. The situations in which it was suggested such remedies might be appropriate included those where there was such an intermingling of assets that it was impossible to untangle the ownership of individual assets and consolidation would benefit all creditors, and where creditors had dealt with the members of a corporate group as a single economic unit and did not rely upon their separate identity in extending credit. While those insolvency laws that included provision for consolidation relied upon the court to assess the existence of appropriate conditions, another approach allowed an insolvency representative to consolidate where certain requirements were met and all creditors consented to the consolidation.

38. In support of consolidation, it was observed that, since intra-group trading was increasingly a norm, consolidation could enable an insolvency representative to focus on external debts of the group because intra-group debts disappeared as a result of consolidation.

39. The scope of consolidation was discussed with respect to whether such an order could include both insolvent and solvent members of a group. Although that remedy was generally used in the context of members against which insolvency proceedings had commenced, it was noted that under some laws it might be possible to include solvent members (paragraph 35 of A/CN.9/WG.V/WP.74/Add.1). Additional situations in which consolidation might be appropriate were suggested, including where consolidating the members might lead to greater return of value for creditors, whether because of the structural relationship between the members and the manner in which they conducted their business and financial relationship or because of the value of assets common to the whole group, such as intellectual property in a process conducted across numerous group members and the product of that process. Such an approach could serve the goal of consolidation as a tool for enhancing the overall distribution to creditors. In response, it was said that substantive consolidation seldom increased recovery for all creditors; rather, it generally effected a levelling of recoveries by decreasing the recoveries of some creditors and increasing the recoveries of others. The only situation in which substantive consolidation was likely to result in increased recovery for all creditors was where it was impossible to untangle the ownership of individual assets across the group. A further situation might occur where there was no real separation between the members of a group, with the group structure being maintained solely for dishonest or fraudulent purposes.

40. The possibility of achieving consolidation by agreement through a reorganization plan was also suggested. Some laws permitted a plan to include proposals for a debtor to be consolidated with other members of a group, whether insolvent or solvent, which could be implemented if creditors approved the plan. The same result could be achieved in practice in other jurisdictions which did not have strict requirements concerning the plan, although it was noted that problems

might arise where a solvent member of a group was to be included in such a proposal.

41. It was suggested that a further issue to be considered was how secured and priority creditors should be treated in consolidation, particularly where the priority creditors of one group member (such as employees) would interact in consolidation with the secured creditors of another group member. One solution mentioned was to exclude external secured creditors from the process of consolidation and cancel the interests of secured creditors internal to the group. Another issue to be considered was that of timing, as consolidation could take place at an early stage of the proceedings or later when it emerged that to do so would enhance the value to be distributed to creditors.

42. Where consolidation orders were to be made by a court, it was agreed that there needed to be clear criteria against which judges could assess the relevant issues.

(b) Avoidance

43. It was recalled that the Legislative Guide included a number of recommendations on avoidance, including recommendations 90 and 91 on transactions with “related persons”. “Related person” was a term defined in the glossary to the Legislative Guide and could include members of a corporate group. It was pointed out, however, that since recommendation 90 referred only to the length of the suspect period for transactions with related persons, additional provisions might be needed for such transactions in the corporate group context.

44. It was noted that certain domestic legislation established a rebuttable presumption that transactions among corporate group members and between those members and the shareholders of that corporate group would be detrimental to creditors, and could therefore be avoided. However, it was also said that a number of those transactions might be entered into for legitimate purposes and should not automatically be subject to that treatment. It was added that a broad application of avoidance might hinder access to financing in the context of reorganization.

45. It was suggested that further consideration should be given to the relationship between avoidance of intra-group transactions, substantive consolidation and the ability of the single administrator to deal with intra-group transactions, as well as between avoidance and subordination.

(c) Subordination

46. It was noted that in certain circumstances the existence of a special relationship between the enterprise in insolvency proceedings and a creditor could lead to subordination of that creditor’s claim to claims of other creditors. It was suggested that that special relationship might also exist between members of the same corporate group, leading to the possible subordination of intra-group credits.

47. In response, it was noted that automatic subordination of intra-group credits might be perceived as a punitive measure and lead to unfair results as many intra-group transactions had a legitimate purpose. It might also ultimately disadvantage the creditors of the members holding subordinated credits. In that respect, it was suggested that the appropriateness of subordination as a remedy might differ as between liquidation and reorganization.

5. Definition of a “domestic corporate group”

48. Having completed its discussion of the remedies, the Working Group considered a possible definition or description of the term “corporate group” on the basis of the material included in the glossary in A/CN.9/WG.V/WP.74.

49. It was agreed that while it might be difficult to reach a definition that could be used both for insolvency and other purposes, it was nevertheless important to reach a common understanding of what might identify a “corporate group”. It was pointed out that solutions to the treatment of corporate groups in insolvency could not be reached by way of a definition, nor should that definition lead to legal consequences. It was suggested that a working definition should be wide enough to include different types of corporate groups common to different countries and regions, such as family-controlled corporate groups, and enterprises that were not incorporated as these were commonly part of a group. One proposal was that a corporate group could be understood as a number of enterprises associated by common or interlocking holdings or allied by control or the capacity to control, where the enterprise need not be incorporated and capacity to control could include those corporate groups based on a contractual arrangement. That suggestion was generally supported.

C. International issues

1. Centre of main interests (COMI)

50. The Working Group considered the concept of COMI and how criteria additional to the presumptions contained in article 16 of the UNCITRAL Model Law on Cross-Border Insolvency might be developed. It was noted that in those jurisdictions where the concept of COMI was used, whether under the EC Regulation on insolvency proceedings or the Model Law, it was a developing concept and a number of factors sufficient to rebut the presumption of the registered office had been identified. Those factors included the location of centres of production and command and control, of bank accounts and accounting services and the place where design, marketing and other economic activities took place.

51. It was noted that neither the EC Regulation nor the Model Law addressed the concept of COMI in terms of corporate groups. In practice, the COMI of each member of a corporate group could be located in a different jurisdiction, leading to proceedings being commenced in each jurisdiction on the basis of the various factors noted above. It was pointed out that in cases where the COMI of a number of group members was found to be in one jurisdiction, there was the potential for creditors, including employees, who were located in jurisdictions different to that of the COMI to be disadvantaged, for instance with respect to filing claims and participating in hearings. It was also pointed out that it was not always possible to ascertain what the COMI of members of a corporate group might be before the insolvency proceedings commenced.

52. Although the discussion proceeded from experience with the Model Law and the EC Regulation, it was suggested that a broader approach to COMI in the group context should be adopted, as those texts did not apply universally. Some support was expressed in favour of developing a concept of “group COMI” that would enable proceedings covering all insolvent members of a group to be filed in one jurisdiction. One suggestion was that the concept of “group COMI” might

incorporate notions of centre of main interest, establishment and presence of assets, as well as taking into account creditor connections and issues of control.

53. It was questioned whether definition of such a concept was possible and how it would be recognized and enforced universally. It was pointed out that most jurisdictions established criteria or connecting factors that gave a debtor the standing to commence insolvency proceedings in a particular jurisdiction. It was recalled that those factors had been discussed in the context of the Legislative Guide (Part two, chapter one, paras. 12 to 19). Even if one court took the view that the COMI of the corporate group fell under its jurisdiction and it could therefore hear applications with respect to other members of that group, other courts would not necessarily concur with that decision in the absence of a binding obligation to do so. In addition, different views might be taken with respect to the inclusion of an enterprise in a corporate group, particularly an international corporate group; for example, some courts might regard as a subsidiary what others might regard as a domestic company, notwithstanding its connection to members of a group located elsewhere.

54. The difficulties of achieving an agreed definition suggested the need to focus on facilitating coordination and cooperation between the various courts in which insolvency proceedings against different members of a corporate group might be commenced, whilst acknowledging the desirability of avoiding a multiplicity of proceedings in the corporate group context.

2. Definition of an “international corporate group”

55. The Working Group considered how an international corporate group might be defined and the characteristics that would distinguish it from a domestic corporate group (see above, paras. 48-49). It was pointed out that a definition that focused on common characteristics and found wide international support was desirable.

56. One proposal was that an international corporate group could be understood as an ensemble of companies subject to the legislation of different countries, bound by capital or control and organized in a coordinated manner. In order not to exclude unincorporated entities and possibly individuals from such a group it was suggested that, as in the discussion of the domestic context, the term “enterprises” could be substituted for “companies”. A further proposal included additional references to the types of connections that might be found between members of a corporate group, such as shared assets, shared management and the control or ability to control the interests of one or more members of the group by making binding decisions with respect to their financial and economic activities.

57. It was suggested that the international nature of a group should be more clearly described. What was required was not simply the existence of offices of group members in different jurisdictions, but rather economic activity or the presence of assets that would be sufficient to establish jurisdiction for the purposes of commencing insolvency proceedings in those different jurisdictions.

58. After discussion, the Secretariat was requested to develop a definition of what might constitute an “international corporate group”, taking into account the various observations made.

3. Remedies

(a) Joint administration

59. One view was that joint administration was as essential in the international context as in the domestic context to ensure that members of a corporate group could be jointly administered, facilitating timely reorganization, greater return of value to creditors and minimization of costs. It was pointed out, however, that while in the domestic context there might be procedures that would enable proceedings commenced in different jurisdictions to be brought together, such procedures did not generally exist at the international level. At that level, proceedings in different jurisdictions would involve diversity of assets, creditors, laws, priorities and so forth. Additional questions concerned the choice of jurisdiction from which joint administration should be conducted, the treatment that might be applicable to solvent members in different jurisdictions and the ability of the insolvency representatives to operate in different jurisdictions, particularly those in which they were not qualified under the relevant law.

60. It was acknowledged that in some situations there might be a need for parallel proceedings to address some of these difficulties, although in general a multiplicity of proceedings should be avoided in order to facilitate coordination and cooperation. Adoption of the Model Law would provide the local rules necessary to achieve that cooperation. There was some agreement that while joint administration should be recommended, further proposals on how it could be achieved might not be possible at this stage of the discussion.

(b) Consolidation

61. It was noted that, while benefits could arise from the consolidation of insolvency proceedings in the context of cross-border insolvency, the international dimension added further complexity, such as the need to adopt criteria for currency conversion, which suggested the need for an even higher threshold than for domestic proceedings. Other issues that might create difficulty related to different procedures for distribution and the recognition of claims, as well as to the differences that might arise from territorial as opposed to universal approaches to insolvency.

62. It was noted that consolidation in the cross-border context might require harmonization of the treatment of security interests in the various jurisdictions, which varied considerably, to the point that certain security interests might have no equivalent in other legal systems.

4. Post-commencement finance

63. The general view was expressed that access to post-commencement finance was key to the success of reorganization, and that such access was possible only in cases where the lender obtained adequate guarantees of recovery of its capital. It was added that those guarantees might not be available in certain jurisdictions which emphasized the protection of pre-commencement security interests, as well as in other jurisdictions lacking the commercial framework to support post-commencement finance, thus hindering reorganization of corporate group members located in those jurisdictions.

64. Concerns were raised as to the feasibility of introducing in certain legal systems the notion of an overarching rank of security interests for the benefit of the lender of the post-commencement finance, sometimes referred to as a “super-

priority”. In that respect, it was added, difficulties might be encountered where enforcement of a reorganization plan contemplating such “super-priority” would be sought in courts other than those of the jurisdiction in which the plan was approved, and especially when the change in the ranking of security interests would affect assets held by solvent members of the corporate group. In that context, it was noted that providing adequate protection for the interests of the creditor of the solvent subsidiary, as well as preventing the exploitation of the solvent subsidiary for the exclusive benefit of the insolvent parent company, would also be desirable goals.

65. It was suggested that some of those concerns might be addressed through the use of protocols, subject to the approval of all courts concerned. In response, it was noted that, while such an approach would ensure adequate representation of all stakeholders, it might also be excessively time-consuming, especially in light of the strict timeline dictated by the financial needs of an insolvent corporate group.

66. Alternatively, it was suggested that a solution might be sought along the lines of certain procedures applicable to cross-border merger of companies. That would entitle courts with jurisdiction over the relevant assets to pass a judgment on the balancing of the various interests at stake and request adequate guarantees to ensure the desired balance was achieved.

67. The Working Group concluded that further discussion of the matter would be desirable and that such discussion should take place on the basis of recommendations 63 to 68 of the Legislative Guide and their application in the international context of corporate groups.

D. Scope of future work

68. The secretariat informed the Working Group on the progress of the work relating to the use of protocols in cross-border insolvency and of the preparation of a report on that topic for consideration by the Commission at its fortieth session in 2007.

69. It was agreed that the Working Group’s current discussion of the treatment of corporate groups in insolvency suggested the need for further work. The UNCITRAL Legislative Guide on Insolvency Law and the UNCITRAL Model Law on Cross-Border Insolvency provided a sound basis for the unification of insolvency law and the integrity of those texts should be maintained in any future work. Therefore, the current work was intended to complement those texts, not to replace them.

70. It was suggested that a possible method of work would entail the consideration of those provisions contained in existing texts that might be relevant in the context of corporate groups and the identification of those issues that required additional discussion and the preparation of additional recommendations. Other issues, although relevant to corporate groups, could be treated in the same manner as in the Legislative Guide and Model Law. The possible outcome of that work might be in the form of legislative recommendations supported by a discussion of the underlying policy considerations.

71. Referring to the decision of the Commission at its last session (A/61/17, para. 209 (b)), it was agreed that, within the given mandate, the Working Group would act flexibly in the manner in which the work on domestic and international post-commencement financing would be conducted.

**B. Note by the Secretariat on the treatment of corporate groups in insolvency,
submitted to the Working Group on Insolvency Law at its thirty-first session**

(A/CN.9/WG.V/WP.74 and Add.1-2) [Original: English]

A/CN.9/WG.V/WP.74

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I. Glossary

1. The following terms, commonly found in the law and literature relating to corporate groups, may have different meanings in different jurisdictions or may be common to one legal tradition and not to others. They are included in this note to provide orientation to the reader and facilitate a common understanding of the issues.

(a) Corporate group

“The word ‘group’ is generally applied to a number of companies which are associated by common or interlocking shareholdings, allied to unified control or capacity to control” (Australia: *Walker v Wimbourne* (1976) ACLR 529 at 532).

“Close and common management links, as well as an interlocking web of complex mutual shareholdings are features sufficient in de facto terms to constitute the various companies in question within the group as being properly described as such, being responsive to the needs and interests of each other as corporate entities through their management” (UK: *Re Enterprise Gold Mines NL* (1991) 3 ACSR 531 at 540).

“A group of undertakings, which consists of a parent undertaking, its subsidiaries and the entities in which the parent undertaking or its subsidiaries hold a right to participate, as well as undertakings linked to each other by a relationship within the meaning of Article 12 (1) of Directive 83/349/EEC” (relating to consolidated accounts). (Article 2, Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial).

(b) Control

The power normally associated with the holding of a strategic position within the corporate organization that enables its possessor to dominate directly or indirectly those organs entrusted with decision-making authority, generally with respect to financial and operating policies.

A company can be considered to control another if it directly or indirectly holds a percentage of the capital that confers upon it the majority of the voting rights in the general assemblies of the second company; when the first company alone holds the majority of the voting rights in the second company pursuant to an agreement concluded with other members or shareholders and which is not contrary to the interests of the second company; when the first company actually makes, due to the voting rights which it holds, the decisions concerning the interests of the second company. A company is presumed to exercise this control when it directly or indirectly holds a percentage of the voting rights higher than 40 per cent and when no other member or shareholder directly or indirectly holds a percentage higher than its percentage (France: Commercial Code, article L233-3).

“Control ... may also rest in an entity holding less than a majority of the voting shares in a company if by virtue of management contracts, conditions in credit arrangements, voting trusts, license or franchise agreements, or other elements, it has the power to exercise decisive influence over the activities of the company in question” (Obligations of Multinational Enterprises and their Member Companies, Institut de droit international, (1995)).

(c) Holding or parent corporation

A holding company or parent company is a company that directly or indirectly owns enough voting stock in another firm to control management and operations by influencing or electing its board of directors. The term may signify a company that does not produce goods or services itself, but whose purpose is to own shares of other companies (or own other companies outright).

(d) Subsidiary corporation

A company that is owned or controlled by another company belonging to the same group of companies. Usually, a subsidiary is incorporated under the laws of the State in which it is established (Obligations of Multinational Enterprises and their Member Companies, Institut de droit international, (1995)).

When a company owns more than half of the capital of another company, the second company is regarded as the subsidiary of the first company (France: Commercial Code, article L233-1).

(e) Parent-subsidiary relationship

A parent-subsidiary relationship exists whenever a corporation holds a strategic position within the corporate decision-making organization of the latter, which gives it a power to directly or indirectly influence its business affairs. Criteria to support the existence of such a relationship would include: the holding of a majority of capital; the holding of a majority voting capital; the holding of a power to elect the majority of management and supervisory boards; the holding of financial, personal, contractual, or any other linkages which are able to create for one of the corporations a strategic controlling position as defined above (Antunes, Jose Engracia, *Liability of Corporate Groups*, Kluwer 1994).

(f) Branch

A unit of a larger entity not separately incorporated in the State where it is established or engaged in operation (Obligations of Multinational Enterprises and their Member Companies, Institut de droit international (1995)).

(g) Related/associated/affiliated corporation

“(jj) “Related person”: as to a debtor that is a legal entity, a related person would include: (i) a person who is or has been in a position of control of the debtor; and (ii) a parent, subsidiary, partner or affiliate of the debtor” (UNCITRAL Legislative Guide on Insolvency Law).

(h) Pooling order (effect is same as substantive consolidation)

An order permitting assets and liabilities of the corporate group in liquidation to be “pooled” or collected together into a single insolvency estate for the general benefit of unsecured creditors.

(i) Contribution orders

Orders by which a court can require a solvent group company to contribute specific funds to cover all or some of the debts of other groups companies in liquidation.

(j) Consolidation

(i) *Procedural consolidation* (referred to in this note as joint administration) where insolvency proceedings or separate entities are consolidated for administration purposes to promote procedural convenience and cost efficiencies, but the assets and liabilities of the debtors remain separate and distinct, with the substantive rights of claimants unaffected.

(ii) *Substantive consolidation* permits the court in insolvency cases involving related entities in appropriate circumstances to disregard the separate identity of the entities to consolidate and pool their assets and liabilities and treat them as though held and incurred by a single entity — creating a single estate for the general benefit of creditors of all consolidated entities.

(k) Joint administration (see consolidation)

(l) Shadow and de facto directors

A shadow director is a person in accordance with whose directions or instructions the directors of the company are accustomed to act (Section 741 (2), UK Companies Act 1985). A company may be a shadow director of another company.

A de facto director can be a shareholder or an officer or director of a parent company who actually perform the functions of a director or hold themselves out as such, but has not been formally appointed as a director.

(m) Transfer pricing

Transfer pricing refers to the pricing of goods and services within a multi-divisional organization. Goods from the production division may be sold to the marketing division, or goods from a parent company may be sold to a foreign subsidiary. The choice of the transfer prices affects the division of the total profit among the parts of the company. It can be advantageous to choose them so that, in terms of bookkeeping, most of the profit is made in a country with low taxes.

(n) Off-balance sheet

Off balance sheet usually means an asset or debt or financing activity not on the company's balance sheet. Examples of off-balance-sheet financing include joint ventures, research and development partnerships, and operating leases (rather than purchases of capital equipment), where the asset itself is kept on the lessor's balance sheet, and the lessee reports only the required rental expense for use of the asset.

(o) Consolidated accounts

Consolidated accounts are financial statements that factor the holding company's subsidiaries into its aggregated accounting figure, presenting the group as a single entity.

II. Background

A. Introduction

2. Most jurisdictions recognize the "corporation", an entity on which a legal personality separate from the individuals comprising it, whether as owners, managers, or employees, is conferred. As a legal or juristic person, a corporation is capable of enjoying and being subject to certain legal rights, duties, and liabilities, such as the capacity to sue and be sued, to hold and transfer property, to sign contracts and to pay taxes. The corporation also enjoys the characteristic of perpetuity, in the sense that its existence is maintained irrespective of its members at any given time and over time, and shareholders can transfer their shares without affecting the entity's corporate existence. Corporations may also have limited liability, whereby investors will only be liable for the amount they have intentionally put at risk in the enterprise. Without that limitation, investors would put their entire assets at risk for every business venture they entered into. A corporation depends on a legal process to obtain its legal persona and once formed,

will be subject to the regulatory regime applying to entities so formed. That law generally will determine not only the requirements for formation, but also the consequences of formation, such as the powers and capacities of the company, the rights and duties of its members and the extent to which members may be liable for the company's debts. The corporate form can thus be seen as promoting certainty in the ordering of business affairs, as those dealing with a corporation know that they can rely upon its legal personality and the rights, duties and obligations that attach to it.

3. The business of corporations is increasingly conducted, both domestically and internationally, through "corporate groups". The term "corporate group" covers a large number of different forms of economic organization based upon the single corporate entity and for a working definition may be loosely described as two or more corporations that are linked together by some form of control (whether direct or indirect) or ownership (see below). The size and complexity of corporate groups may not always be readily apparent, as the public image of many is that of a unitary organization operating under a single corporate identity.

4. Corporate groups have been in existence for some time, emerging in some countries, according to commentators, at the end of the 19th and beginning of the 20th century through a process of internal expansion, which involved companies taking control of their own financial, technical or commercial capacities. These single entity enterprises then expanded externally to take legal or economic control of other corporations. Initially these other corporations may have been in the same market, but eventually the expansion encompassed corporations working in related fields and later in fields that were different or unrelated, whether by reference to product or geographical location or both.¹ One of the factors supporting this expansion, at least in some jurisdictions, was the legitimatization of ownership of the shares of one corporation by another corporation; a phenomenon originally prohibited in both common law and civil law systems.

5. Throughout this expansion, corporations retained and continue to retain, their separate legal personality even though, as one commentator suggests, "the individual corporation ceased to be the most significant form of organization in the 1920s and 1930s",² with the single operating company now probably the typical form of organization only for small private businesses. Corporate groups are now ubiquitous in both emerging and developed markets, with common characteristics of operations across a large number of often-unrelated industries, often with family ownership in combination with varying degrees of participation by outside investors. The largest economic entities in the world include not only countries, but also equal numbers of multinational enterprises. Major multinational groups may be responsible for significant percentages of Gross National Product worldwide and have annual growth rates and annual turnovers that exceed those of many countries.

6. Despite the reality of the corporate group, much of the legislation relating to corporations and particularly to their treatment in insolvency, deals with the single corporate entity as if it were the norm. Despite the absence of legislation, judges in many countries, faced with issues that can better be addressed by reference to the single enterprise than the single corporate entity, have developed solutions to achieve results that better reflect the economic reality of modern business.

¹ Antunes, Jose Engracia, *Liability of Corporate Groups*, Kluwer 1994, chapter 1.

² Hadden, *Inside Corporate Groups*, 1984 *International Journal of Sociology of Law*, 12, 271-28 at 271.

B. Nature of corporate groups

7. Corporate group structures may be simple or highly complex, involving numbers of wholly or partly owned subsidiaries, operating subsidiaries, sub-subsidiaries, sub-holding companies, service companies, dormant companies, cross-directorships, equity ownership and so forth. They may also involve other types of entity, such as special purpose entities (SPE), joint ventures, offshore trusts and partnerships.

8. Corporate groups may have a hierarchical or vertical structure, with succeeding layers of parent and controlled companies, which may be subsidiaries or other types of affiliated or related companies, operating at different points in a production or distribution process. They may also have a more horizontal structure, with many sibling groups companies, often with a high degree of cross-ownership, operating at the same level in that process. The businesses they conduct may be in a related field or in a diverse range of unrelated fields. It has been suggested that horizontal groups are more common in some parts of the world, such as Europe, while vertical groups are more common in others, such as the USA and Japan.

9. The research literature on business groups clearly shows that they can be based on different types of alliances such as bank relationships, interlocking board directorates, owner alliances, information sharing, joint ventures, and cartels. The research also shows that business group structure varies across corporate governance systems. Japan's keiretsu are organized either vertically or horizontally and develop across industries. They generally include a bank, a holding or a trading company, and a diverse group of manufacturing firms. In contrast, Korea's chaebol are typically controlled by a single family or a small number of families and are uniformly vertically organized. Business groups in China have developed their own unique structure: the groups are large multi-industry entities with strong ties to the state but not to particular families.³

10. The degree of financial and decision-making autonomy in groups can vary considerably. In some groups, corporations may be active trading entities, with primary responsibility for their own business goals, activities and finances. In others, strategic and budgetary decisions may be centralized, with group corporations operating as divisions of a larger business and exercising little independent discretion within the cohesive economic unit. A parent corporation may exercise close control by allocating equity and loan capital to group members through a central group finance operation, deciding their operational and financial policies, setting performance targets, selecting directors and other key personnel, and continuously monitoring their activities. The power of the group may be centralized in the ultimate holding company or in a company further down the group chain, with the holding company owning the key corporate group shares, but not having any direct productive or managerial role. The largest groups might have their own banks and perform the principal functions of a capital market. Group financing might involve intra-group lending between the holding company and subsidiaries, involving loans both from and to the holding company. Intra-group lending might be working capital or unpaid short-term debt such as unpaid dividends or credit in respect of intra-group trading; they may or may not involve the payment of interest.

³ Khanna, T. and Yafeh, Y., *Business Groups in Emerging Markets: Paragons or Parasites?*, European Corporate Governance Institute, 2005.

11. In some countries, family ties play an important connecting factor in corporate groups and it may be the case, for example, that the more important family members and close associates of family members will sit on the board of the holding company of a group, with members of that board spread around the boards of group companies so that there is a web of interlinked common directorships, enabling the family to maintain control over the group. For example, a chart of the Tata group in India shows a complex web of shared directorships between the eighteen-member board of the holding company, Tata Sons Ltd, and 45 other members of the group.⁴ Interlocking directorships are common in many countries: a survey in France, Germany, Italy, UK and USA showed that 2 out of every 10 corporate directors sat in at least 3 separate corporations.⁵

12. In some countries, corporate groups have enjoyed close ties to governments and government policies, such as those affecting access to credit and foreign currency and competition have significantly influenced the development of groups. Equally, there are examples where government policies have targeted the operations of groups, removing certain type of preferential treatment, such as access to capital.

13. The structure of many corporate groups shows the dimension and potential complexity of the arrangements. A 1997 survey in Australia of the Top 500 listed companies showed that 89 per cent of those companies controlled other companies; the greater the market capitalization of a listed company, the more companies it was likely to control (this ranged from an average of 72 controlled companies for those companies with the largest market capitalization to an average of 9 for the smallest); 90 per cent of controlled companies were wholly owned; the number of vertical subsidiary levels in a corporate group ranged from 1 to 11, with an overall average of 3 to 4.⁶ In other countries the figures are much larger. A study based upon the 1979 accounts and reports of a number of large British-based multinationals had to be abandoned with respect to two of the largest groups, with 1200 and 800 subsidiaries respectively, because of the impossibility of completing the task. The researchers also noted that few people inside the group could have a clear understanding of the precise legal relationships between all members of the group and that none of the groups studied appeared to have its own complete chart.⁷ Similarly, the group charts of several Hong Kong property groups such as Carrian, which failed over 20 years ago, ran to several pages and a reader would have needed a good magnifying glass to identify the subsidiaries. Today, the group chart of the Federal Mogul group, an automotive component supplier, when blown up to the point where you can read the names of all the subsidiaries, fills a wall of a small office. The group chart of Collins and Aikman, another automotive group, is printed in a book, with sub-sub-groups having the complexity of structure of many domestic groups of companies.

14. The degree of integration of a corporate group might be determined by reference to a number of factors,⁸ which might include the economic organization of the group (e.g., whether the administrative structure is arranged centrally or

⁴ Bikram De, *The Incidence and performance effects of interlocking directorates in emerging market business groups: evidence from India*, Indira Gandhi Institute of Development Research, April 2003.

⁵ Antunes, note 1, p. 45.

⁶ Cited in Companies and Securities Advisory Committee (CASAC), *Corporate Groups Final Report*, 2000 (Australia), paragraph 1.2.

⁷ Hadden, note 2, p. 273.

⁸ CASAC, note 6, paragraph 1.7.

maintains the independence of the various members, whether subsidiaries depend on the group for financing or loan guarantees, whether personnel matters are handled centrally, the extent to which the parent makes key decisions on policy, operations and budget and the extent to which the businesses of the group are integrated vertically or horizontally); how the group manages its marketing (e.g., the importance of intra-group sales and purchases, the use of common trademarks, logos and advertising programmes and the provision of guarantees for the products); and the public image of the group (e.g., the extent to which the group presents itself as a single enterprise, and the extent to which the activities of the constituent companies are described as operations of the group in external reports, such as those for shareholders, regulators and investors).

15. The legal structure of a group as a number of separate legal entities is not necessarily determinative of how the business of the group is managed. While each corporation is a separate entity, management may be arranged in divisions along product lines and subsidiaries may have one or many product lines with the result that they fall across different divisions. In some cases, management may treat wholly owned subsidiaries as if they were branches of the parent company.

16. As noted above, corporate groups may involve other types of entity such as SPEs, joint ventures, offshore trusts and partnerships. One issue in the context of groups is how these types of entities and arrangements will be treated for insolvency purposes.

Special purpose entities

17. Special purpose entities (SPE, also known as a “special purpose vehicle” or “bankruptcy-remote entity”) are created to fulfil narrow or temporary objectives, such as the acquisition and financing of specific assets, primarily to isolate financial risk or enhance tax efficiency. An SPE is typically a subsidiary owned almost entirely by the parent corporation; certain jurisdictions require that another investor own at least 3 per cent. Its asset and liability structure and legal status generally makes its obligations secure even if the parent becomes insolvent. The corporation establishing the SPE can accomplish its purpose without having to carry any of the associated assets or liabilities on its own balance sheet, thus they are “off-balance sheet.”

18. As financial markets have become more and more sophisticated, SPEs have been used for a wide variety of transactions. These include: securitizing financial assets such as various types of loans; credit card receivables; finance and aircraft operating leases; real estate mortgages; and aircraft and ship financing. The SPE will acquire the underlying asset from the originator of the transaction, and will then issue notes, bonds or other securities. The benefits to the originator of proceeding in this manner may include: removal of the underlying asset or asset pool from the balance sheet; improved liquidity; reduction of interest, currency and maturity risk to which the originator may have been exposed by the underlying asset pool; and improving return on assets and capital.

19. SPEs may also be used for competitive reasons to ensure intellectual property, such as for the development of new technology, is owned by a separate entity that is not affected by pre-existing licence agreements.

Joint venture

20. A joint venture is often a contractual arrangement or partnership between 2 or more parties to pursue a joint business purpose. Such an arrangement may sometimes result in the formation of one or more legal entities that may involve both parties contributing equity, and sharing in the revenues, expenses, and control of the enterprise. The venture could be for one specific project only, or a continuing business relationship. Joint ventures are widely used in an international context, as some countries require foreign corporations to form joint ventures with a domestic partner in order to enter a market. This requirement often results in technology and managerial control being transferred to the domestic partner.

21. Forming a joint venture might assist in spreading costs and risks; improving access to financial resources; providing economies of scale and advantages of size; and facilitating access to new technologies and customers or to innovative managerial practices. It may also serve competitive and strategic goals such as influencing structural evolution of an industry; pre-empting competition; creating stronger competitive units; and facilitating transfer of technology and skills, as well as diversification. The question to be considered in the group context is whether a joint venture is considered to be a part of a corporate group and how the form of the joint venture affects the answer to this question.

Offshore trusts

22. An offshore trust is a conventional trust that is formed under the laws of an offshore jurisdiction. They are similar in nature and effect to onshore trusts, involving a transfer of assets to a trustee to manage for the benefit of a person or class or persons. A number of jurisdictions have modified their laws to make their jurisdictions more attractive to the establishment of such trusts. Offshore trusts may be formed for tax purposes or asset protection. In practice the effectiveness of such trusts may be limited if the insolvency law of the home jurisdiction of the person transferring the assets operates to set aside transfers to the trusts, and transactions entered into to defraud creditors.

Cross-guarantees

23. In many countries a significant method of corporate-group capital raising is cross-guarantee financing, where each company within a group guarantees the performance of the others. Implementing cross-guarantee claims in liquidation has proved difficult in some jurisdictions and they have sometimes been set aside.

24. In one jurisdiction (Australia), cross-guarantees may operate to reduce the regulatory burden on companies by bestowing accounting and auditing relief on companies that are party to the arrangement. The deed of cross-guarantee makes the group of companies that are party to that deed akin to a single legal entity in many respects and operates as a form of voluntary contribution or pooling in the event that one or more of the companies party to the deed goes into liquidation while the cross-guarantee is still operative. One advantage of this arrangement is that creditors and potential creditors can focus on the consolidated position for those entities, rather than on the individual financial statements of the wholly owned subsidiaries that are party to the deed.

C. Reasons for conducting business through corporate groups

25. Diverse factors shape the formation, operation and evolution of corporate groups, ranging from legal and economic factors to societal, cultural, institutional and other norms. State leadership, inheritance customs, kinship structures (including inter-generational considerations), ethnicity and national ideology, as well as the level of development of the legal (e.g., effectiveness of contract enforcement) and institutional framework supporting commercial activity may influence corporate groups in different environments. Some studies suggest that group structures can make up for under-developed institutions, with consequent benefits for transaction costs.⁹

26. The advantages of conducting business through a corporate group structure¹⁰ may include assisting to reduce commercial risk, or maximize financial returns, by enabling the group to diversify its activities into various types of businesses, each operated by a separate group company. One company may acquire another to expand and increase market power, at the same time preserving the acquired company and continuing to operate it as a separate entity to utilize its corporate name, goodwill and public image. Expansion may occur to acquire new or technical or management skills. Once formed, groups may continue to exist and proliferate because of the administrative costs associated with rationalizing and liquidating redundant subsidiaries.

27. A group structure may enable a group to attract capital to only part of its business without forfeiting overall control, by incorporating that part of the business as a separate subsidiary and allowing outside investors to acquire a minority shareholding in it. A group structure may enable a group to lower the risk of legal liability by confining high liability risks, such as environmental and consumer liability, to particular group companies, thus isolating the remaining group assets from this potential liability. Better security for debt or project financing may be facilitated by moving specific assets into a separate company incorporated for that purpose, thus ensuring that the lender has a first priority over the whole or most of the new company's property. A separate group company may also be formed to undertake a particular project and obtain additional finance by means of charges over its own assets and undertaking or may be required for the purpose of holding a government license or concession. A group structure can simplify the partial sale of a business as it may be easier, and sometimes more tax effective, to transfer the shares of a group company to the purchaser, rather than sell discrete assets. A group may also be formed incidentally when a company acquires another company, which in turn might be a holding company for various other companies.

28. Meeting prudential or other statutory requirements may be easier where the corporations subject to those regulatory requirements are separate members of a group. In the case of multinational groups, the domestic law of particular countries in which the group wishes to conduct business may require that local businesses be conducted through separate subsidiaries (sometimes subject to minimum local equity requirements) or impose other requirements or limitations, relating for example to employment and labour regulation. Arrangements not involving equity have been used for foreign expansion because of, for example, local obstacles to equity participation, the level of regulation imposed upon foreign investment

⁹ Khanna and Yafeh, note 3, p. 21.

¹⁰ The following reasons are discussed in CASAC, note 6, paragraph 1.8.

operations and the relative cost advantages of those types of arrangement. Another relevant factor for multinational groups may be geographical imperatives, such as the need to acquire raw materials or to market products through a subsidiary established in a particular location. A related consideration of increasing importance that perhaps relates more to where parts of the groups structure are to be located than to the question of whether or not to organize a business through a group structure, is the importance of local law on issues such as cost and simplicity of incorporation in the first instance, obligations of incorporations and treatment of the group in insolvency (these issues are discussed below under international considerations). Differences in law across different jurisdictions can significantly complicate these issues.

29. Other key drivers for complicated group structures include fiscal considerations and their influence on the flow of money within groups. The incidence of tax is often cited as the reason for the formation of and subsequent growth of corporate groups and many legal systems have traditionally given weight to the economic unity of related corporate entities. While separate taxation of individual corporate entities might be the underlying principle, it may be qualified to fulfil basic purposes such as protecting the revenue interests of governments and alleviating the tax burden that would otherwise result from the separate taxation of each member of the group.¹¹ Measures that take into account the connections between parent and subsidiary companies include tax exemptions for intra-group dividends; group relief; and measures aimed at combating tax evasion. Tax exemptions may be available, for example, on the dividends paid by a company to its resident corporate shareholders and for intra-group dividends where companies are linked by substantial ownership. Tax credits may be allowed for the foreign tax paid on the underlying profits of the subsidiary and for the foreign tax that is charged directly on a dividend. Group relief might be available where related companies can be treated as a single fiscal unit and file consolidated accounts. Losses of one subsidiary may be offset against the income of another or profits and losses may be pooled amongst members of the group.

30. As a result of the importance of fiscal considerations, inter-company pricing policies and national taxation rates and policies often determine the distribution of assets and liabilities within corporate groups. Differential corporate tax rates across jurisdictions, as well as certain exceptions (such as reduced tax rates for profits from manufacturing activities or financial services income) applicable in some jurisdictions may make those jurisdictions more attractive than others that have higher tax rates and fewer or no exceptions. Nevertheless, tax authorities may have the right to revisit transfer-pricing structures¹² aimed at locating profits in low taxation domiciles.

31. Choices such as between establishing a branch or a subsidiary might also be affected by fiscal regulation where, for example, repatriation of profits from a foreign subsidiary may be effected tax free by loan repayments to a parent company or may be tax free provided the parent owns a specified percentage (ranging from 5-20 per cent) of the foreign company's share capital; interest on funds borrowed to finance the acquisition of a subsidiary can be offset against their profits and as already noted, the subsidiaries profits and losses can be offset against each other in

¹¹ International Investment and Multinational Enterprises — Responsibility of parent companies and their subsidiaries, OECD, 1979.

¹² See glossary.

a consolidated tax return. Business activities have also been divided between two or more corporations to exploit tax allowances, limits imposed on the amounts of tax allowances or progressive rates of taxation. Other reasons might include: taking advantage of differences in accounting methods, taxable years, depreciation methods, inventory valuation methods and foreign tax credits; segregating activities that if combined in a single taxable entity, might be disadvantageous in fiscal terms; and taking advantage of favourable treatment for certain activities (e.g., anticipated or potential sales, mergers, liquidations or intra-family gifts or bequests) that is available for some operations, but not for others.

32. Accounting requirements also have a role to play in determining the structure of corporate groups. In some jurisdictions, certain devices such as “agent only” subsidiaries might be created to manage certain aspects of the business and enable the holding company to avoid submitting detailed trading accounts for that subsidiary, which is just an agent of the holding company that owns all of the relevant assets.

33. Many of these benefits of conducting business through a corporate group may be illusory. Protection against devastating losses may fall away as a result of group financing agreements; intra-group trading and cross-guarantees; letters of comfort¹³ given to group auditors and the inclination of major creditors, and particularly bankers, to ensure that they have the indemnity of the top company in any group.

34. To avoid doubt, group structures are not required from the accounting point of view — accountants are just as happy with consolidating branches as groups of subsidiaries. It seems probable that the banking, commercial and legal sectors often fail to appreciate the accounting aspects of groups of companies. The opportunities for misunderstanding will increase in the transition to new international financial reporting standards and many groups change their consolidation approach from one that has regard for the substance of transactions, to one that requires legal form to prevail over substance. It was the “off-balance” accounting structures that made Enron, WorldCom and other failures possible and the need for clarity of financial statements is widely acknowledged.

D. Defining the “corporate group” — ownership and control

35. Although the existence of groups and the importance of relationships between the members of groups are increasingly acknowledged, both in legislation and court decisions, there is no coherent body of rules that directly governs those relationships in a comprehensive manner. In jurisdictions where there is legislation that recognizes corporate groups, it may not specifically deal with the regulation of such groups, by way of commercial or corporate legislation, but rather be contained in legislation on taxation, corporate accounting, competition and mergers or other issues; legislation addressing the treatment of corporate groups in insolvency is rare. Furthermore, an analysis of legislation that does address aspects of corporate groups

¹³ A letter of comfort is generally provided by a parent corporation to persuade another entity to enter into a transaction with a subsidiary. It may include various types of undertaking, none of which would amount to a guarantee, which may include an undertaking to maintain its shareholding or other financial commitment to a subsidiary; using its influence to see that the subsidiary meets its obligation under a primary contract; or confirming that it is aware of a contract with the subsidiary, but without any express indication that it will assume any responsibility for the primary obligation.

reveals a diversity of approach to the various issues associated with groups, not only between jurisdictions but also on a comparison of the different legislation within a single jurisdiction. Thus different tests may apply to what constitutes a group for different purposes, although there may be common elements, and where those tests employ a particular concept, such as “control”, definitions may be broader or narrower, depending upon the purpose of the legislation, as noted above.

36. While much legislation avoids specifically defining the term “corporate group”, several concepts are common to determining what relationships between corporate entities will be sufficient to constitute them as a corporate group for certain specific purposes, such as extending liability, accounting purposes, taxation and so on. These concepts are found both in legislation and in numerous court decisions on corporate groups in various countries and generally include aspects of ownership and control or influence, both direct and indirect, although in some examples only direct ownership or control or influence is considered. Some examples consider ownership by reference to a formal relationship between the companies, such as what constitutes a holding-subsidary or parent-subsidary relationship. This may be determined by reference to a formal standard — the holding, whether directly or indirectly, of a specified percentage of capital or votes. Examples of those percentages vary from as little as 5 per cent to more than 80 per cent. Those specifying lower percentages generally consider additional factors such as the ones discussed below as indicators of control. In some examples, the percentages establish a rebuttable presumption as to ownership, while higher percentages establish a conclusive presumption.

37. Other examples of what constitutes a corporate group adopt a more functional approach and focus on aspects of control, or controlling or decisive influence (referred to in this note as control), where “control” is often a defined term. The key elements of control include actual control or capacity to control, either directly or indirectly, financial and operating policy and decision-making. Where the definition includes capacity to control, it allows for a passive potential for control, rather than focussing upon control that is actively exercised. Control may be obtained by ownership of assets, or through rights or contracts that give the controlling party the capacity to control. What is important is not so much the strict legal form of the relationship, such as parent-subsidary, between the entities, but rather the substance of that relationship.

38. Factors that might indicate the existence of control of one entity by another could include: the ability to dominate the composition of the board of directors or governing body of the second entity; the ability to appoint or remove all or a majority of the directors or governing members of the second entity; the ability to control the majority of the votes cast at a meeting of the board or governing body of the second entity; and the ability to cast or regulate the casting of, a majority of the votes that are likely to be cast at a general meeting of the second entity, irrespective of whether that capacity arises through shares or options. Information that may be relevant to consideration of these factors might include: the company’s incorporation documents; details about the company’s shareholding; information relating to substantive strategic decisions of the company; internal and external management agreements; details of bank accounts and their administration and authorized signatories; and information relating to employees.

E. Regulation of corporate groups

39. Regulation of corporate groups is generally based on one of two approaches or in some cases on a combination of the two: the separate entity approach (which is the traditional approach and by far the most prevalent) and the single enterprise approach.

40. The separate entity approach relies on several basic principles, foremost of which is the separate legal personality of each group company. It is also based upon the limited liability of shareholders of each group company and the duties of directors of each separate group entity to that entity.

41. The separate legal personality of a corporation generally means that it has its own rights and duties, irrespective of who controls it or owns it (i.e., whether it is wholly or partly owned by another company) and its participation in the activities of the group. The debts it incurs are its debts and the assets of the group generally cannot be pooled to pay for these debts. Contracts entered into with external persons do not automatically involve the parent company and a parent company cannot take into account the undistributed profits of other group companies in determining its own profits. Limited liability of a corporation means that unlike in a partnership or sole proprietorship, members of a corporation have no liability for the corporation's debts and obligations, with the result that their potential losses cannot exceed the amount they contributed to the corporation by purchasing shares.

42. The single enterprise approach, in comparison, relies upon the economic integration of members of a corporate group, treating the group as a single economic unit that operates to further the interests of the group as a whole, or of the dominant corporate body, rather than of individual members. Borrowing may be conducted on a group basis, with group treasury arrangements being used to offset the credit and debit balances of each group company; group companies may be permitted to operate at a loss, or be undercapitalized, as part of the overall group financial structure and strategy; assets and liabilities may be moved between group companies in various ways; and intra-group loans, guarantees or other financial arrangements may be entered into on essentially preferential terms.

43. While many countries follow the separate entity approach, there are some countries that recognize exceptions to strict application of that approach and others that have introduced, either by legislation or through the courts, a single enterprise approach that applies to certain situations.

44. Some of the circumstances in which strict application of the separate entity approach is overridden in one country (Australia)¹⁴ include: consolidation of corporate group accounts for a company and any controlled entity; related party transactions (a public company is prohibited from giving any financial benefit, including intra-group loans, guarantees, indemnities, releases of debt or asset transfers, to a related company unless that transaction is approved by shareholders or is otherwise exempt); cross-shareholding (companies are generally prohibited from acquiring, or taking a security over, the shares of any controlling company or issuing or transferring their shares to any controlled company); and insolvent trading (a holding company which ought to suspect the insolvency of a subsidiary can be made liable for the debts of that subsidiary incurred when it was insolvent).

¹⁴ CASAC, note 8, para. 1.73.

45. A few countries (Germany, Portugal) have established various categories of corporate groups that can operate as a single enterprise, in exchange for enhanced protection of creditors and minority shareholders. In Germany, corporate group structures involving public companies are divided into 3 categories: (a) integrated groups; (b) contract groups; and (c) de facto groups, to which a set of harmonized single enterprise principles dealing with corporate governance and liability applies.

(a) Integrated groups are based upon a vote, by a specified proportion of shareholders of the holding company, which in turn owns a specified proportion of the shares of the subsidiary, to approve the complete integration of the subsidiary. The holding company will have unlimited power to direct the subsidiary, in return for the holding company being jointly and severally liable for the debts and obligations of the subsidiary;

(b) Contract groups can be formed by a specified proportion of shareholders of each of two companies entering into a contract that grants one company (the parent) the right to direct the other company, provided the directions are consistent with the interest of the parent company or the group as a whole. In return for giving the parent company the right of control, minority shareholders and creditors are given enhanced protection; and

(c) De facto groups are those where one company exercises, either directly or indirectly, a dominant influence over another company. Although not created by any formal arrangement, there must nevertheless be systematic involvement by the parent in the affairs of the controlled company.

46. In one country where single enterprise principles have been introduced into corporate legislation (New Zealand), directors of wholly or partly owned subsidiaries may act in the interests of the holding company rather than their subsidiary company; there are provisions for streamlined group mergers; and legislation also permits contribution and pooling orders (discussed in A/CN.9/WG.V/WP.74/Add.1).

47. In another country (USA), commercial regulatory laws affecting corporate groups increasingly use single enterprise principles to ensure that the policy underlying specific commercial legislation cannot be undermined or avoided by the use of corporate groups. The courts have assisted in this development, selectively introducing the single enterprise concept to achieve the underlying policies of the legislation. The concept has been applied to insolvency law to avoid specified intra-group transactions, to support intra-group guarantees and to achieve consolidation (discussed in A/CN.9/WG.V/WP.74/Add.1). The courts also have the power to alter the priority of claims in the liquidation of a group entity, either by treating some intra-group loans to that entity as equity rather than debt, or by subordinating intra-group loans to that entity to the claims of its external creditors.

[III. The onset of insolvency: domestic issues and IV. International issues appear in A/CN.9/WG.V/WP.74/Add.1 and 2 respectively]

A/CN.9/WG.V/WP.74/Add.1 [Original: English]

**Note by the Secretariat on the treatment of corporate groups in insolvency,
submitted to the Working Group on Insolvency Law at its thirty-first session**

[I. Glossary, II. Introduction appear in A/CN.9/WG.V/WP.74]

ADDENDUM

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III. The onset of insolvency: domestic issues

1. Corporate groups may be structured in ways that minimize the threat of insolvency to one or more members of the group, by entering into cross-guarantees, indemnities and similar types of arrangements. Where problems do arise, a parent company may seek to avoid the insolvency of any of its group members in order to preserve its reputation and maintain its credit in commercial and financial spheres by providing additional finance and agreeing to subordinate intra-group claims to other external liabilities.

2. However, if the complexity of a corporate group's structure is disturbed by the onset of financial difficulty affecting one or more, or even all, of the members of a group that leads to insolvency, problems arise simply because the group is constituted by members that are each recognized as having a separate legal personality and existence. Since the great majority of domestic insolvency and corporate laws omit provision for the effective liquidation or restructuring of groups, even though group issues might be addressed outside the insolvency area in relation to accounting treatment, regulatory issues and taxation, the absence of legislative authority to the contrary or judicial discretion to intervene in insolvency

means that each entity has to be separately considered and, if necessary, separately administered in insolvency. In certain situations, such as where the business activity of a company has been directed or controlled by a related company, the treatment of the group companies as separate legal personalities may operate unfairly. It may, for example, prevent access to the funds of one company for the payment of the debts or liabilities of a related debtor company (except where the debtor company is a shareholder or creditor of the related company), notwithstanding the close relationship between the companies and the fact that the related company may have taken part in the management of the debtor or acted like a director of the debtor and caused it to incur debts and liabilities. Furthermore, where the debtor company belongs to a group of companies, it may be difficult to untangle the specific circumstances of any particular case to determine which group company particular creditors dealt with or to establish the financial dealings between group companies.

3. Much of what already exists in domestic law regarding the insolvency of corporate groups concentrates on the circumstances in which it might be appropriate to consolidate insolvency estates. What is lacking is more comprehensive guidance on how corporate group insolvency should be considered and in particular, whether and in what circumstances corporate groups should be treated differently from the insolvency treatment of a single corporate entity.

A. Commencement

4. The standard to be met for commencement of insolvency proceedings is central to the design of an insolvency law. As the basis of insolvency proceedings, this standard is instrumental to identifying the debtors that can be brought within the protective and disciplinary mechanisms of the insolvency law and determining who may make an application for commencement, whether the debtor, creditors or other parties. The UNCITRAL Legislative Guide on Insolvency Law¹ notes that commencement standards should be transparent, certain and flexible with respect to the types of proceedings available and the ease with which those proceedings can be accessed.

5. The appropriateness of the solutions recommended by the Legislative Guide should be examined for application to corporate groups. A first issue is the insolvency test to be applied and to whom it will apply in the group context. A second question relates to who can apply to commence insolvency proceedings in respect of members of a group or the group as a whole, and the factors that are relevant to that determination.

1. Commencement standard

6. Many insolvency laws require a debtor to be insolvent (however defined) for commencement of insolvency proceedings. On that basis, insolvency proceedings could generally only be commenced against those members of the group that satisfied the insolvency test. One issue of relevance to the question of whether or not a member of a corporate group satisfies the test of insolvency is how various liabilities such as intra-group indebtedness and potential liabilities under a cross-guarantee should be treated.

¹ UNCITRAL Legislative Guide, part two, chapter I, section B, paras. 20-21.

7. In some cases, where for example the structure of the group is diverse, involving unrelated businesses and assets, the insolvency of one or more members of the group may not affect other members or the group as a whole and the insolvent members can be administered separately. In other cases, however, the insolvency of one member of a group may cause financial distress in other members or in the group as a whole, because of the group's integrated structure, with a high degree of interdependence and linked assets and debts between its different parts. In those cases, the ability to consider the group as a whole would facilitate development of an insolvency solution for the whole of the group and avoid piecemeal commencement of proceedings over time if and when additional members of the group became affected by the insolvency proceedings initiated against the originally insolvent members. It would also overcome the difficulties that might arise with respect to identifying the appropriate debtor within the corporate structure against which proceedings should be commenced.

8. This scenario raises one of the key issues in the treatment of groups of companies in insolvency, that is, the degree to which the corporate group is economically and organizationally integrated and more importantly, the extent to which a highly integrated group should be treated differently in insolvency to a group where individual members retain a high degree of independence. That treatment might suggest, for example, that insolvency proceedings could be extended to include group members who do not satisfy the commencement standard, because it is necessary for the greater good of the group as a whole that they be included in those proceedings. A related issue might be whether the court should have the discretion to join or consolidate applications to commence proceedings against more than one insolvent member of a group to facilitate the joint administration of those proceedings. Joint administration is discussed below.

2. Persons permitted to apply

9. As a matter of general insolvency law, the Legislative Guide recommends that creditors and debtors should be permitted to make an application for commencement of insolvency proceedings. It does not specifically address the issue of commencement with respect to corporate groups² and the questions to be considered would include whether a parent company could apply to commence proceedings against one or more members of its group, whether one member is permitted to apply in respect of all other members, including the parent and whether the insolvency representative appointed in respect of one member of the group could apply with respect to another member, for example, could the insolvency representative of the parent apply for commencement of proceedings against a subsidiary?

10. In addition, are there any public policy elements that might suggest that some provision for the possible intervention of a regulatory body (such as a securities agency or corporate regulatory agency) might be appropriate? A related question concerns application for commencement by creditors. While there may be no reason to justify departure from the approach that recommends creditors be permitted to apply for commencement of both liquidation and reorganization in the case of a corporate group, the structure of a corporate group may make it particularly difficult for a creditor to identify the specific part of the group with which it dealt and

² UNCITRAL Legislative Guide, part two, chapter 1, paras. 20-79.

provide the evidence necessary to satisfy the commencement standard.³ In some cases, particularly where the group is loosely organized, the particular debtor may be easily identified. Where there is a high degree of integration, however, the answer may be less clear, especially where the creditor believed that it was dealing with the group as a single enterprise.

11. With respect to intervention by a regulatory or supervisory body, the Legislative Guide notes⁴ that in addition to the right of the Government as a creditor to initiate insolvency proceedings, some countries provide an additional more broadly based power for government or other supervisory authorities to use the insolvency regime to shut down a business in circumstances where the authority is not necessarily a creditor but closure of the business is considered to be in the public interest. In that case, a demonstration of illiquidity is not always necessary, enabling the Government to terminate the operations of businesses that have been engaged in certain activities, generally of a fraudulent or criminal nature or involving serious breach of regulatory obligations or a combination of these. The Legislative Guide suggests that given the potential for such a power to be misused in circumstances unrelated to insolvency and for public interest grounds to be very broadly defined, it is highly desirable that such powers be available only in very limited circumstances and only as a last resort in the absence of appropriate remedies under other laws. These limited circumstances may include the use of insolvency powers in conjunction with enforcement of laws, such as laws relating to money-laundering or regulation of securities, where a demonstration of insolvency may not be required. The Legislative Guide recommendations do not specifically refer to regulatory authorities as being amongst those parties permitted to make an application for commencement of insolvency proceedings.⁵

12. As a general rule, insolvency laws respect the separate legal status of each member of a corporate group and a separate application for commencement of insolvency proceedings is required to be made for each insolvent entity. There are some limited exceptions, however, which allow a single application to be extended to other members of the group where, for example, all interested parties consent to the inclusion of more than one company (South Africa); or there is a relationship between the companies that is variously described, but involves, for example, a significant degree of interdependence or control; intermingling of assets; the fictitious nature of the group; unity of identity or other similar characteristics (South Africa, Spain, France, Argentina, Mexico, USA⁶) that need not necessarily arise from the legal relationship (such as holding company-subsidiary) between the companies. Such joint administration (sometimes also referred to as procedural or administrative consolidation) does not affect the substantive rights of each of those debtors or the liability of each member to its own creditors. Appointment of the same insolvency representative for each company would facilitate their joint administration.

³ UNCITRAL Legislative Guide, part two, chapter I, paras. 37-41 and 48-53, for a discussion of creditor application.

⁴ UNCITRAL Legislative Guide, part two, chapter I, para. 42.

⁵ Recommendation 14 provides that: "The insolvency law should specify the persons permitted to make an application for commencement of insolvency proceedings, which should include the debtor and any of its creditors."

⁶ USA: Bankruptcy Rule 1015 explicitly contemplates joint administration.

B. Effects of commencement

13. The ways in which the commencement of insolvency proceedings will affect the debtor and its assets are discussed in detail with respect to debtors engaged in commercial activities in the UNCITRAL Legislative Guide on Insolvency Law (part two, chapter I). The Legislative Guide does not, however, discuss how those effects might or should differ in the case of the insolvency of one or more members of a corporate group. Some of the effects that might need to be considered in the group context include the following.

14. First, the appointment of the same insolvency representative in respect of each group member. While many insolvency laws do not address this question, there are some jurisdictions where this has become a practice (including Australia, England and Germany). This has also been achieved to a limited extent in some cross-border insolvency cases in the EU (discussed further below). If this could be achieved, it would facilitate coordinated resolution of the insolvencies of the relevant group members. As a safeguard against possible conflict, the insolvency representative could be required to give an undertaking or be subject to a practice rule or statutory obligation to seek direction from the court in the event a conflict arises. If appointment of the same insolvency representative were not possible, consideration might need to be given to what additional powers insolvency representatives might require to facilitate coordination of the different proceedings, including: sharing and disclosure of information; proposal and negotiation of coordinated reorganization plans (unless preparation of a single group plan was possible as discussed below); use of avoidance powers and so forth. A related question concerns whether an insolvency representative appointed to the insolvency proceedings of a parent company should have any powers that might override those of insolvency representatives appointed in respect of subsidiaries?

15. Second, the manner in which potential conflicts (for example, because of cross-guarantees members of a group, inter-group debts, wrongdoing by one member of a group that affects another member) should be addressed.

16. Third, the need, in jurisdictions that permit management to remain in office (whether under supervision or not), for any further or special provisions in the case of a corporate group.

17. Fourth, the appropriateness of provisions relating to application of a stay or suspension in the case of a single debtor to the case of a corporate group.

18. Fifth, provisions applicable to use and disposal of assets of the affected group members once proceedings commence and whether any special provisions are required, particularly with respect to the use of cash.

19. Sixth, the need for special provisions with respect to post commencement finance for a corporate group (or some two or more of its members). This issue is of particular relevance in relation to corporate groups in an international setting (discussed in A/CN.9/WG.V/WP.74/Add.2). The Legislative Guide recognizes that the continued operation of the debtor's business after the commencement of insolvency proceedings is critical to reorganization and, to a lesser extent, liquidation where the business is to be sold as a going concern. To maintain its business activities, the debtor must have access to funds to enable it to continue to pay for crucial supplies of goods and services, including labour costs, insurance, rent, maintenance of contracts and other operating expenses, as well as costs

associated with maintaining the value of assets. The Guide notes, however, that many jurisdictions restrict the provision of new money in insolvency or do not specifically address the issue of new finance or the priority for its repayment in insolvency. The Legislative Guide⁷ includes a number of recommendations aimed at promoting the availability of finance for continued operation or survival of the debtor's business, providing appropriate protection for the providers of post-commencement finance, as well as appropriate protection for those parties whose rights may be affected by the provision of post-commencement finance.

C. Usual or special types of proceedings

20. Many insolvency laws make liquidation and reorganization available as mechanisms to resolve a debtor's financial difficulties. In the context of a corporate group, are these mechanisms sufficient or is there a need for them to be adapted to meet the special needs of corporate group insolvency and, in addition, to provide for the possibility of applying other remedies or relief that are peculiar to a corporate group?

D. Reorganization of two or more members of a group

21. Where insolvency proceedings are commenced against two or more members of a group, irrespective of whether or not those proceedings can be jointly administered, there is a question of whether it will be possible to reorganize the debtors through a single reorganization plan. If such a course of action were to be possible, what provisions amending, or in addition to, those discussed in detail in the reorganization chapter of the Legislative Guide⁸ might be required to address fundamental matters such as: parties competent to propose the plan or participate in its proposal; nature and content of a plan; safeguards concerning a plan; convening and conduct of creditors meetings in respect of a plan; claims of creditors; classification of classes of creditors; voting of creditors and approval of a plan; objections to approval of the plan (or confirmation where it is required); and implementation of a plan.

22. A single reorganization plan would need to take into account the different interests of the different groups of creditors. It would also need to achieve an appropriate balance between the rights of those different groups of creditors with respect to approval of the plan and ensure that rejection by the creditors of one subsidiary would not mean the plan could not go ahead, provided safeguards analogous to those included in recommendation 152 of the Legislative Guide were available. These safeguards might include that the benefits to be received under the plan are equal to or greater than the creditors would have received in liquidation and fair in relation to their position relative to creditors of other group members.

23. These issues generally are not addressed in insolvency laws, although it is suggested that in some jurisdictions applications for commencement by members of the group will be jointly administered as a matter of practice and negotiations will

⁷ UNCITRAL Legislative Guide, part two, chapter II, section D, para. 94, Purpose of legislative provisions preceding recommendation 63. Chapter II, section D is set forth in document A/CN.9/582/Add.5.

⁸ UNCITRAL Legislative Guide, part two, chapter IV.

commonly lead to consensual plans of reorganization in which different entities are effectively treated as one, although the court never formally considers the issue of substantive consolidation (USA).

E. Remedies

24. Because of the nature of corporate groups and the way in which they operate, there may be, as noted above, a complex web of financial transactions between members of the group and creditors may have dealt with different members or even with the group as a single economic entity, rather than with individual members. Untangling the ownership of assets and liabilities and identifying the creditors of each member of the group may involve a complex and costly legal inquiry. However, because of adherence to the separate entity approach, creditors of each entity must in general look to that entity for payment of their debt, and it will generally become necessary, where insolvency proceedings have commenced against one or more of the members of that group, to untangle the ownership of assets and liabilities of the insolvent entities.

25. Where this untangling can be effected, adherence to the separate entity principle operates to limit creditor recovery to the assets of the insolvent entity. Where it cannot be untangled or reasons exist to treat the group as a single enterprise, some laws include remedies that allow the single entity approach to be set aside in specified circumstances. Historically, these remedies have been developed to overcome the perceived inefficiency and unfairness of the traditional separate entity approach in specific cases. These include, for example, extending liability for external debts to other, solvent members of the group, as well as to office holders and shareholders; contribution orders; pooling or (substantive) consolidation orders;⁹ setting aside intra-group transactions; or subordinating intra-group lending. Because of the potential inequity caused to one creditor group when forced to share *pari passu* with creditors of another entity that may be less solvent, these remedies are not universally available, generally not comprehensive and apply only in restricted circumstances. Those remedies involving extension of liability may involve “piercing” or “lifting the corporate veil”, by which shareholders, who are generally shielded from liability for the corporation’s activities, can be held liable for certain activities. The other remedies discussed here do not, although in some circumstances the effect may appear to be similar.

1. Extension of liability

26. Extending the liability for external debts and, in some cases, the actions of the insolvent group member to solvent group members and relevant office holders is a remedy available to individual creditors on a case-by-case basis and depends upon the circumstances of that creditor’s relationship with the debtor.

27. Many laws recognize circumstances in which exceptions to limited liability are available and related companies and relevant office holders could be found liable for the debts and actions of a group member. Some laws adopt a more prescriptive approach and the circumstances are strictly limited; other laws adopt a more expansive approach and courts are given broad discretion in evaluating the circumstances of a particular case on the basis of specific guidelines. In both cases,

⁹ See glossary A/CN.9/WG.V/WP.74.

however, the basis for extending liability beyond the insolvent entity is the relationship between the insolvent and related group members in terms of both ownership and control. A further relevant factor may be the conduct of the related company to the creditors of the insolvent company.

28. Whilst there are different formulations of the circumstances in which liability might be extended, examples generally fall into the following categories, although it should be noted that not all laws reflect all of these categories and to some extent they may overlap:

- (i) Exploitation or abuse by one member of the group (perhaps the parent) of its control over another member of the group, including operating a subsidiary continually at a loss in the interests of the controlling company (Argentina, Australia, South Africa, France, Brazil);
- (ii) Fraudulent conduct by the dominant shareholder, which might include fraudulently siphoning off a subsidiary's assets or increasing its liabilities (France), or conducting the affairs of the subsidiary with an intent to defraud creditors (Liechtenstein);
- (iii) Operating a subsidiary as the parent company's agent, trustee or partner (Australia, UK);
- (iv) Conducting the affairs of the group or of a subsidiary in such a way that some classes of creditors might be prejudiced (for example, incurring liabilities to employees of one group member) (Poland);
- (v) Artificial fragmentation of a unitary enterprise into several entities for the purposes of insulating the single entity from potential liabilities; failure to follow the formalities of treating group members as separate legal entities, including disregarding the limited liability of subsidiaries (USA) or confusing personal and corporate assets; or where the corporate group structure is a mere sham or façade (UK, France), such as where the corporate form is used as a device to circumvent statutory or contractual obligations;
- (vi) Inadequate capitalization of the company, so that it does not have an adequate capital basis for carrying out its operations (USA). This may apply at the time of establishment, or be the result of depletion of the capital by way of refunds to shareholders or if shareholders have drawn more than distributable profits;
- (vii) Misrepresentation of the real nature of the corporate group, leading creditors to believe that they are dealing with a single enterprise, rather than with a member of a group;
- (viii) Misfeasance, where any person, including another group member, can be required to compensate for any loss or damage to a company arising from fraud, breach of duty or other misfeasance, such as actions causing significant injury or environmental damage (USA, UK);
- (ix) Wrongful trading, where directors, including shadow directors,¹⁰ of a company have a duty to monitor, for example, whether the company can properly continue carrying on business in the light of its financial condition and are required to file for insolvency within a specified period once the

¹⁰ Shadow or de facto directors: see glossary A/CN.9/WG.V/WP.74.

company has become insolvent (France, UK, Russia). Permitting or directing a group member to incur debts when it is or is likely to become insolvent would fall into this category; and

(x) Failing to observe regulatory requirements, such as keeping regular accounting records of the subsidiary (France).

29. Generally, the mere incidence of control or domination of a subsidiary by a parent, or other form of close economic integration within a corporate group, is not regarded as sufficient reason to justify disregarding the separate legal personality of each group member and piercing the corporate veil.

30. In a number of the examples where liability might be extended to the parent or other company in control of an insolvent subsidiary, that liability may include the personal liability of the members of the board of directors of the parent or controlling company (who may be described as *de facto* or shadow directors). While directors of a company may generally owe certain duties to that company, directors of a group company may be faced with balancing those duties against the overall commercial and financial interests of the group. Achieving the general interests of the group, for example, may require that the interests of individual members be sacrificed in certain circumstances. Some of the factors that might be relevant to determining whether directors of a controlling company will be personally liable for the debts or actions of an insolvent controlled company include: whether there was active involvement in the management of the controlled entity; whether there was grievous negligence or fraud in the management of the insolvent company; whether the parent's management could be in breach of duties of care and diligence or there was abuse of managerial power; or whether there was a direct relationship between the management of the controlled entity and its insolvency. In some jurisdictions, directors may also be found criminally liable. One of the principal difficulties with extending liability in such cases is proving the behaviour in question to show that the controlling company was acting as a *de facto* or shadow director.

31. There are also laws that provide for parent companies to accept liability for debts of subsidiaries by contract, especially where the creditors involved are banks (Belgium, Netherlands), or voluntary cross-guarantees (Australia). Under other laws, which provide for various forms of integration of groups of companies (Germany, Portugal) the principal company can be jointly and severally liable to the creditors of the integrated companies, for liabilities arising both before and after the formalization of the integration.

2. Contribution orders

32. Another possible remedy in insolvency is the contribution order, by which a court can require a solvent group company to contribute specific funds to cover all or some of the debts of other group companies in liquidation. New Zealand introduced contribution orders into its Corporations Act in 1980.¹¹ The provisions specify that the companies should be "related" companies as defined.¹² Under that

¹¹ New Zealand Companies Act, Sections 271-272.

¹² Companies Act 1993, section 2 (3) which defines the necessary relationship by reference to a holding/subsidiary relationship; direct or indirect ownership of more than half of the shares of the company, either by the other company, members of the other company or companies related to the other company; the businesses of the companies have been conducted in such a way that they cannot be separated; or both the insolvent company and the related company have one of these specified relationships with a third company.

definition, the related company need not be the ultimate holding company of the group member in liquidation. The New Zealand provisions permit a liquidator, creditor or shareholder of a company in liquidation to make an application for a contribution order, although payment must be made to the liquidator, not to the applicant.

33. The New Zealand legislation provides that, in making a contribution order, the court must take into account certain specified circumstances. These include: the extent to which a related company took part in the management of the company in liquidation; the conduct of the related company towards the creditors of the company in liquidation, although creditor reliance on the existence of a relationship between the companies is not sufficient grounds for making an order; the extent to which the circumstances giving rise to liquidation are attributable to the actions of the related company; and such other matters at the court thinks fit.¹³

34. Because of the problem of reconciling the interests of the two sets of unsecured creditors that have dealt with the two separate companies, the power to make a contribution order is not commonly exercised. Furthermore, the courts have taken the view that a full contribution order may be inappropriate if the effect is to threaten the solvency of the related company not already in liquidation. However, conduct of the solvent company after commencement of the liquidation of its related company might be relevant if it indirectly or directly affects the creditors of the related company, such as with respect to failure to perform a contract.

3. Substantive consolidation or pooling

35. A further type of remedy is that of substantive consolidation or pooling (referred to in this note as consolidation). As noted above, where joint administration occurs, the assets and liabilities of the debtors remain separate and distinct, with the substantive rights of claimants unaffected. Consolidation, however, permits the court in insolvency cases involving members of the same group to disregard the separate identity of the group members in appropriate circumstances and consolidate their assets and liabilities and treat them as though held and incurred by a single entity. This has the effect of creating a single estate for the general benefit of all creditors of all consolidated entities. Consolidation might extend to solvent companies belonging to the same group and to individuals, such as the controlling shareholder.

36. The availability of this type of order is not widespread and, where it is available, in general it is not widely used. Few jurisdictions provide statutory authority for consolidation orders.¹⁴ Because of the absence of direct statutory authority or a prescribed standard for the circumstances in which such orders can be made, the courts of some jurisdictions have played a direct role in developing these orders and delimiting the circumstances in which they can be made. As is the case with contribution orders, these circumstances are very limited and tend to be those where there is a high degree of integration of the members of a corporate group and it would be difficult, if not impossible, to disentangle the assets and liabilities of the different entities.

37. The principal concerns with the availability of such orders, in addition to those associated with the fundamental issue of overturning the separate entity principle,

¹³ New Zealand Companies Act, Section 272 (1).

¹⁴ See New Zealand Corporations Act 1980, s272.

include the potential unfairness caused to one creditor group when forced to share *pari passu* with creditors of another entity that may be less solvent and whether the savings or benefits to the collective class of creditors outweighs incidental detriment to individual creditors. An additional issue is the extent to which the availability of consolidation would enable stronger, larger creditors to take advantage of assets that do not and should not properly be available to them. Other considerations include the likelihood that making a consolidation order will encourage creditors who disagree with such an order to seek review of the order, thus prolonging the insolvency proceedings, and the damage likely to be inflicted upon certainty and foreseeability of legal security. Inter-company claims disappear as a result of consolidation and creditors that have security interests in those claims will lose their rights. These concerns have led some commentators to suggest that consolidation should only be available where creditors agree or if not, under careful court control.¹⁵

38. In those jurisdictions where the courts have played a role in developing consolidation orders, they have identified a number of elements considered to be relevant to determining whether or not substantive consolidation is warranted. In each case it is a question of balancing the various elements; no single element is necessarily conclusive and all of the elements do not need to be present. The elements include: the presence or absence of consolidated financial statements; the unity of interests and ownership between the entities; the degree of difficulty in segregating individual assets and liabilities; sharing of overhead, management, accounting and other related expenses among different entities; existence of inter-entity loans and cross-guarantees on loans; the extent to which assets were transferred or funds shifted from one entity to another without observing proper formalities; adequacy of capital; commingling of assets or business operations; common directors or officers; common business location; fraudulent dealings with creditors; and whether consolidation would facilitate a reorganization or is in the interests of creditors. While these many factors remain relevant, some courts have started to focus on two factors in particular, namely, whether creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit, and whether the affairs of the entities are so entangled that consolidation will benefit all creditors.

39. In some jurisdictions where there is no specific legislative authority for consolidation (Australia), voluntary consolidation may nevertheless be facilitated by provisions of the law addressing, for example, group cross-guarantee arrangements; schemes of arrangement; and arrangements between creditors and companies being liquidated or about to be liquidated. It may also be possible for courts to make consolidation orders on a consent basis (Canada). In a recent US case involving an application for consolidation by the parent, creditors of the subsidiary, which was in a much better financial situation, objected to the consolidation. A settlement was agreed whereby those creditors of the subsidiary who objected were promised a substantially greater payout than other unsecured creditors of the parent,¹⁶ thus departing from the strict policy of equal distribution. The possibility of providing

¹⁵ Peter, H., *Insolvency in a Group of Companies, Substantive and Procedural Consolidation: When and How?* In *Challenges of Insolvency Law in the 21st Century*, eds. H. Peter, N. Jeandin, J. Kilborn, Schulthess 2006, p. 206.

¹⁶ *WorldCom and MCI* — Skeel, D. A., *Groups of Companies: Substantive Consolidation in the U.S.*, in *Challenges of Insolvency Law in the 21st Century*, eds. H. Peter, N. Jeandin, J. Kilborn, Schulthess 2006, p. 232.

such an exception to the principle of *pari passu* with respect to consolidation orders has been noted elsewhere.¹⁷

40. In jurisdictions permitting consolidation orders relatively few have been made. In New Zealand's leading case,¹⁸ the court took into account the intermingled corporate group management practices, which included combined board meetings of the various group companies; the use of a single bank account for all the group companies and the policy of using whichever group company was convenient for the various business operations undertaken. In addition to those practices, management had encouraged creditors to treat the corporate group as a single entity, which created confusion among the creditors as to which of the entities they were dealing with and otherwise blurred the legal boundaries of the group companies. The court also concluded that given those arrangements, the liquidity of each group company affected that of the others. A further factor was that the only way to determine the status of various intra-group debts, if a consolidation order were not made, would be through separate legal proceedings, which would invariably increase the cost and length of the liquidation and thereby deplete the funds otherwise available for creditors.

41. The New Zealand court also considered the competing interests of creditors and shareholders and concluded that in insolvency the rights of creditors outweighed those of shareholders, supporting the making of the consolidation order. Moreover, without a consolidation order, the shareholders of some corporate group members would receive a return at the expense of creditors of other group members. The competing interests of shareholders of the different group companies were also to be considered, and in particular the interests of those who were shareholders of some of the companies but not of others.

42. The competing interests of secured and unsecured creditors also need to be considered, and in particular whether the rights of secured creditors should remain unaffected by such an order. The Legislative Guide on Insolvency Law discusses the position of secured creditors in insolvency proceedings and adopts the approach that while as a general principle that the effectiveness and priority of a security interest should be recognized and the economic value of the encumbered assets should be preserved in insolvency proceedings, an insolvency law may modify the rights of secured creditors in order to implement business and economic policies, subject to appropriate safeguards.¹⁹

43. Individual creditors may also be affected by the court treating as invalid any charges, guarantees or other intra-group securities between the companies in liquidation. The New Zealand court in *Re Dalhoff* ruled that an external creditor could not enforce an intra-group guarantee that depended on retaining the separate identity of the group companies in liquidation; that creditor would be treated as an unsecured creditor unless the court considered that it should retain some priority right over other creditors.²⁰

¹⁷ Law Reform Commission of Australia, Report No. 45, General Insolvency Inquiry 1988, para. 856.

¹⁸ *Re Dalhoff and King Holdings Ltd* (1991) 5 NZCLC 66,959.

¹⁹ Annex I of the UNCITRAL Legislative Guide sets forth the sections of the Guide addressing the treatment of secured creditors in insolvency proceedings.

²⁰ See note 18.

44. Consolidation orders may also have taxation implications, where for example, taxation rules rely upon identification of the specific source of any returns to shareholders made after distributions to creditors (Australia).

4. Partial substantive consolidation or pooling

45. Courts in some jurisdictions that permit consolidation (NZ), can make a limited order by exempting the claims of specific unsecured creditors and satisfying them from the particular assets of one of the companies in liquidation where it would be equitable to do so. Partial consolidation might be achieved by: extending the order to only unsecured creditors on the basis that secured creditors have relied upon the single entity principle; extending the order to cover only net equity of the solvent group companies, thus not affecting the rights of the creditors of those solvent entities; making the parent company liable only for the negative net equity of the insolvent group member, thus not affecting that members assets; and limiting the consolidation to those assets and liabilities that are intermingled and excepting those assets whose ownership is clear.²¹

5. Avoidance

46. As the UNCITRAL Legislative Guide on Insolvency Law notes,²² many insolvency laws include provisions which apply retroactively from a particular date (such as the date of application for, or commencement of, insolvency proceedings) for a specified period of time (often referred to as the suspect period) and are designed to overturn those past transactions to which the insolvent debtor was a party or which involved the debtor's assets where they have certain effects, such as reducing the net worth of the debtor or upsetting the principle of equal sharing between creditors of the same rank. The types of transactions to which such provisions apply generally include: transactions intended to defeat, hinder or delay creditors; undervalued transactions; preferential transactions; and transactions with related persons. The Legislative Guide notes the difficulties of proving subjective elements of avoidance requirements, such as the intention of the debtor when entering into the transaction and the subjective knowledge of the counterparty. Such elements would be even more difficult to prove in the corporate group context.

47. Those provisions and the types of transactions to which they apply are relevant in the context of the insolvency of one or more members of a corporate group. In that context, they may affect intra-group financial transactions, such as loans, asset transfers and guarantees, as well as third party mortgages or guarantees provided to external lenders. In some jurisdictions (Australia), payments by a company to a creditor of a related company and a guarantee or mortgage given by one group company to support a loan by an outside party to another group company, may be subject to avoidance if the benefits accruing to the guarantor or mortgagor are outweighed by the detriment incurred by entering into the transaction. Intra-group transactions that might involve a director of one group company breaching their fiduciary duties and the other group company having actual or constructive knowledge of that fact, such as loans, asset transfers or third party mortgages given by a company prior to its liquidation but without any direct or indirect benefit, may also be subject to avoidance.

²¹ H. Peter, note 16, p. 208.

²² UNCITRAL Legislative Guide, part two, chapter II, section F, para. 150.

48. The question to be considered with respect to those types of transactions is how they should be treated in insolvency of corporate groups. For example, should the avoidance provisions applicable in the context of a debtor that is a separate corporate entity apply in the context of corporate groups or is there a need for more extensive provisions that include different categories of transactions? In addition, would a relevant criterion in respect of group transactions be whether the transaction conveyed advantages to the parent company that would not normally be granted between unrelated business entities?

6. Subordination

49. In some cases where consolidation might be inappropriate, other remedies such as subordination might be considered. One example might be where insiders (typically the controlling shareholder or a person related to that shareholder) have behaved in a manner that suggests they may not deserve priority relative to external creditors acting in good faith.

50. Some laws provide for subordination of related company debt to that of outside creditors (Spain, Germany, USA). Under the corporate law of one jurisdiction (USA), courts may review intra-group financial arrangements to determine whether particular funds given to a group company should be treated as an equity contribution (thus enabling subordination to creditors' claims), rather than an intra-group loan, or whether debts owed by a group member in liquidation under any intra-group lending arrangement should be subordinated to the rights of external creditors of that group member. For example, a parent company which is the secured creditor of a controlled company in liquidation may have its claims subordinated to those of unrelated unsecured creditors or even minority shareholders of the controlled company, based upon factors such as: the level of capitalization of the controlled company; the parent company's participation in the management of the controlled company; whether the parent company has sought to manipulate intra-group transactions to its own advantage at the expense of external creditors; or whether the parent company has otherwise behaved unfairly, to the detriment of creditors and shareholders of the controlled company.

51. In one jurisdiction that does not have legislative provisions permitting subordination (UK), the courts may in limited cases postpone the prior rights of intra-group creditors to those of unsecured external creditors, under the principles of unjust enrichment.²³ In another jurisdiction (Australia), a creditor group company may voluntarily agree to subordinate its claims to those of external creditors.²⁴

F. Issues for consideration — domestic treatment of corporate groups in insolvency

52. The foregoing discussion indicates those aspects of the treatment of corporate groups in insolvency that are addressed by laws affecting domestic insolvency; it is clear that most attention has focussed upon the circumstances in which the separate

²³ A legal doctrine stating that if a person receives money or other property through no effort of his own, at the expense of another, the recipient should return the property to the rightful owner, even if the property was not obtained illegally. Most courts will order that the property be returned if the party who has suffered the loss brings a lawsuit.

²⁴ Australia: Corporations Law, s563C.

corporate entity approach can be reconsidered once insolvency proceedings have commenced. Few laws specifically address issues such as the commencement of those proceedings against one or more members of a corporate group or the effects of such commencement. While it may be possible to draw the conclusion, therefore, that the manner in which corporate insolvency laws address those issues in the context of individual corporations is appropriate to the insolvency of one or more members of a corporate group, it is suggested that that may not always be the case.

53. The Working Group may also wish to consider what future work might be undertaken on the treatment of corporate groups in insolvency in light of the following possibilities. In considering those possibilities, the Working Group may wish to adopt a working assumption that any proposals or recommendations are not intended to interfere with the high incidence and increasing sophistication of corporate group structures, nor interfere in or create uncertainty for the multitude of commercial transactions that are entered into with corporate groups (often regardless of the absence or presence of legislation directed at the possible insolvency of or within a group). The prospect or possibility that work on corporate groups could propel corporate groups toward sanctuary in a “safe haven” should be avoided.

54. The Working Group may wish to consider the following issues:

(a) The scope of future work and, in particular, how the term “corporate group” could be defined for that purpose;

(b) Access to insolvency proceedings in the event of the insolvency of one or more members of a corporate group, which might include consideration of:

(i) The circumstances under which it would be appropriate for proceedings to be commenced against all or part of a corporate group and the commencement standard that should apply, in particular to members of the group that may not satisfy that standard but should be included in the proceedings for other reasons;

(ii) The person competent to make an application for commencement;

(iii) The effects of commencement and the extent to which they should differ from those discussed in the UNCITRAL Legislative Guide, for example, with respect to use and disposal of assets;

(c) What relief should be available in insolvency proceedings against a corporate group, including:

(i) Procedural relief, such as whether the same insolvency representative could be appointed to each insolvent group member or the extent to which it would be appropriate for insolvency estates to be jointly administered;

(ii) Substantive relief, such as the extent to which formal relief, protections and remedies would be available against solvent members of a corporate group; the extent to which the limited liability protection of separate entities may be waived; the extent to which two or more members of a group may be liable for the external debts of one of them; the extent to which it would be appropriate to facilitate substantive consolidation of assets and liabilities of group companies, contribution orders and subordination of claims; and

(iii) Other forms of relief that might be appropriate in group situations;

(d) Cooperation between courts and insolvency representatives in a group situation, particular where different insolvency representatives are appointed to different members of the group;

(e) Other issues particular to corporate groups that might require special provisions, such as:

(i) The powers of an insolvency representative appointed in the insolvency of a parent company of a group and the extent to which, for example, that insolvency representative could steer the actions to be taken by the (insolvent) subsidiary;

(ii) Whether provisions additional to the recommendations of the UNCITRAL Legislative Guide on Insolvency Law are required with respect to the provision of post-commencement finance in the corporate group context;

(iii) The extent to which the recommendations on avoidance provisions UNCITRAL Legislative Guide on Insolvency Law should apply in the context of corporate groups and whether there is a need for more extensive provisions that include different categories of transactions, including those between members of the group;

(iv) The extent to which special provisions may be needed in the case of corporate groups where management is permitted to remain in office; and

(v) Whether provisions additional to the recommendations of the UNCITRAL Legislative Guide on Insolvency Law are required with respect to reorganization of corporate groups, in particular with respect to negotiation, approval and implementation of a reorganization plan.

[IV. *International issues appears in A/CN.9/WG.V/WP.74/Add.2*]

A/CN.9/WG.V/WP.74/Add.2 [Original: English]

Note by the Secretariat on the treatment of corporate groups in insolvency, submitted to the Working Group on Insolvency Law at its thirty-first session

*[I. Glossary and II. Introduction appear in A/CN.9/WG.V/WP.74; III. The
onset of insolvency: domestic issues appears in
A/CN.9/WG.V/WP.74/Add.1]*

ADDENDUM

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IV. International issues

A. Introduction

1. In the international context, the models that have been created to address cross-border insolvency issues have always stopped short of dealing satisfactorily with groups. When the United Kingdom's House of Lords sitting under the chairmanship of Lord Hoffmann considered whether the United Kingdom should subscribe to the European Convention on Insolvency Proceedings,¹ the committee commented on the failure of the convention to deal with groups of companies — the most common form of business model. When the convention became the European Council (EC) Regulation No. 1346/2000 of 29 May 2000 on insolvency proceedings

¹ Opened for signature on 23 November 1995.

(the EC Regulation), it still did not address the issue. When the text of what became the UNCITRAL Model Law on Cross-Border Insolvency was debated, groups were “a stage too far”. Subsequently, when the UNCITRAL Legislative Guide on Insolvency Law was being developed, it was recognized that embarking upon a discussion of the topic of corporate groups could significantly hinder progress with the remainder of the Guide and it therefore contains only a limited introduction, and no recommendations, on the subject of groups.

2. A well-reported case that illustrates one of the key problems with respect to groups in the international context was KPN Quest, which failed the day the EC Regulation came into force, 31 May 2002. KPN Quest was a telecoms group that owned cables around Europe and to the US. The main cables were in rings: for the ring around Europe, the French part of the ring was owned by a French subsidiary; the German part by a German subsidiary, and so on. When the Dutch parent failed, many of the subsidiaries were obliged to file for the protection of the court in the jurisdictions in which they were incorporated. No one was able to coordinate the proceedings and it was effectively broken up. A discussion of other international cross-border cases would confirm the shortcomings of the existing system; there is often a clear tension between the traditional separate legal entity approach to corporate regulation and its implications for insolvency and the facilitation of insolvency proceedings against a group or part of a group in a cross-border situation in a manner that would enable the goal of maximizing value for the benefit of creditors to be achieved.

3. The discussion in document A/CN.9/WG.V/WP.74/Add.1 raises a number of questions with respect to treatment of corporate groups in the domestic context that might also be discussed in the cross-border context, both with respect to the commencement of proceedings against members of a corporate group located in different States and the administration of those proceedings. Jurisdictions may have different tests for what qualifies a debtor to apply for commencement of proceedings, as well as different types of proceedings. For example, not all jurisdictions have well-developed proceedings for reorganization and even amongst those that do there are differences. Some, for example, may provide a form of reorganization that permits the debtor to remain in control, while others do not. Some jurisdictions may facilitate reorganization by permitting various types of post-commencement finance, while others do not (discussed further below). Rules on the effects of commencement vary (e.g. the type of stay available and to whom it will apply), as do rules on powers of the insolvency representative with respect, for example, to avoidance of antecedent transactions and the rules on negotiation, approval and implementation of a plan of reorganization.

4. As already stated, few laws recognize the reality of the corporate group and provide comprehensive rules for their treatment in a domestic context, let alone in cross-border situations. Given the ubiquity of corporate groups in modern commerce, there has been a steady increase in recent years in the number of insolvencies involving multinational corporate groups. Problems encountered with the insolvency of corporate groups in the domestic context are multiplied many times when one or more debtors are part of a multinational group, but each is a separate legal entity located in a different jurisdiction, against which separate proceedings must be initiated. Having concurrent proceedings with respect to related companies taking place in different jurisdictions may not be conducive to achieving a global plan because of the many differences in insolvency laws and the procedures available, if any, for coordinating those different proceedings. The

history of cross-border insolvency since the Maxwell case in 1991² underscores the problems encountered in managing numbers of parallel proceedings, and the need for the creative solutions that have been developed and adopted. The following discussion raises a number of issues specific to the treatment of corporate groups in the cross-border context.

B. Jurisdiction to commence insolvency proceedings

5. The UNCITRAL Legislative Guide notes that a debtor must have a sufficient connection to a State to be subject to its insolvency laws. In many cases, no issue as to the applicability of the insolvency law will arise as the debtor will be a national or resident of the State and will conduct its economic activities in the State through a legal structure registered or incorporated in the State. However, where there is a question of the debtor's connection with a State, insolvency laws adopt different tests, including whether the debtor has its centre of main interests in the State, whether the debtor has an establishment in the State or whether it has assets in the State.

1. Centre of main interests (COMI)

6. The EC Regulation uses COMI to determine where "main" proceedings should be commenced within the EU. The UNCITRAL Model Law on Cross-Border Insolvency (the Model Law) also uses the concept of COMI, although somewhat differently to indicate those proceedings that could be recognized as constituting foreign "main" proceedings for the purposes of assistance. Importantly, the Model Law recognizes that the status of those proceedings as main proceedings may change and accordingly that the order for recognition may need to be modified or terminated.

7. Neither the UNCITRAL Model Law nor the EC Regulation define the term; recital 13 of the EC Regulation does however indicate that the term should correspond to "the place where the debtor conducts the administration of his interests on a regular basis and is therefore ascertainable by third parties". Article 16, paragraph 3, of the UNCITRAL Model Law and article 3 of the EC Regulation also provide that the debtor's registered office, or habitual residence in the case of an individual, is presumed to be the centre of main interests, unless it can be shown that the centre of main interests is elsewhere.

8. Much has been written about the concept of "centre of main interests" and how it is to be interpreted, particularly with respect to the EC Regulation. While the Regulation contains the presumption with respect to registered office, the weight to be given to that element and other factors to be taken into consideration in determining COMI have been the subject of a number of cases in the EU in recent years. It is not the purpose of this note to examine the development of that interpretation in detail; some of the cases involving consideration of COMI have been included in previous UNCITRAL documents (see A/CN.9/580, paras. 58-79 and A/CN.9/579, paras. 8-17).

² This case involved the United States and the United Kingdom. United States Bankruptcy Court for the Southern District of New York, Case No. 91 B 15741 (15 January 1992), and the High Court of Justice, Chancery Division, Companies Court, Case No. 0014001 of 1991 (31 December 1991).

9. In its May 2006 decision in the Eurofood IFSC Ltd case,³ the European Court of Justice's principal conclusion was that the presumption that a company's COMI is in the Member State in which its registered office is situated can be rebutted only if objective factors ascertainable by third parties enable it to be established that the COMI is elsewhere. The Court did not consider what those factors might be, but noted that COMI could be in a location different to the registered office where, for example, the company was not carrying out business in the Member State in which its registered office was situated. In contrast, where a company was carrying out its business in the territory of the Member State in which it had its registered office, the mere fact that its economic choices were or could be controlled by a parent company in another Member State was not enough to rebut the presumption in article 3. The court emphasized that in the system established by the Regulation for determining the competence of the courts of the Member States, each debtor constituting a distinct legal entity is subject to its own court jurisdiction.

10. In cases decided before the ECJ decision, some of the factors considered sufficient to rebut the presumption have related to: the extent of a subsidiary's independence with respect to financial, management and policy decision-making; financial arrangements between parent and subsidiary, including capitalization, location of bank accounts and accountancy services; the division of responsibility with respect to provision of technical and legal documentation and signature of contracts; where design, marketing, pricing and delivery of products was conducted; and conduct of office functions. It remains to be seen how the relevance of, and weight attached to, those factors will be affected by the ECJ decision.

11. It has been suggested by one commentator that French cases decided before the ECJ decision indicated that some courts had been influenced by the fact that in many cases it was practical to bring together group insolvencies and to deal with them in the country where proceedings concerning the parent company have commenced.⁴ Cases cited involved French parent companies with subsidiaries in other Member States. This could also be said about the courts of a number of other jurisdictions in the EU where COMI has been applied, in appropriate cases, in a manner that resulted in the component parts of an insolvent group being administered in one country. Those cases have involved EU Member States, as well Member and non-Member States, such as Switzerland. It has been suggested that those cases achieved better results because of, for example, better coordination and the appointment of the same insolvency representative for all group members. The extent to which this can be achieved is, however, dependant upon the existence of factors supporting a determination that the COMI of all group members is in the same Member State. Those factors will not always exist and the insolvency of two or more group members may require proceedings to be commenced in different jurisdictions with respect to those different group members.

³ C-341/04; available at <http://eur-lex.europa.eu>. Eurofood was registered in Ireland in 1997, with its registered office in Dublin. It is a wholly owned subsidiary of Parmalat SpA, a company registered in Italy, and its principal objective was the provision of financial facilities for the companies in the Parmalat group.

⁴ Jean-Luc Vallens, Eurofenix, Summer 2006, pp. 10-11.

2. Presence of assets and establishment

12. These two tests are discussed in the UNCITRAL Legislative Guide.⁵ In the UNCITRAL Model Law and the EC Regulation, which both define the term “establishment” although slightly differently, proceedings commenced where a debtor has an establishment are secondary or non-main proceedings; in the case of the Regulation, those proceedings are restricted to liquidation of those assets of the debtor situated in that State. The Model Law does not accord recognition to proceedings commenced on the basis of presence of assets, but acknowledges that there might be a need in some cases to commence local proceedings to deal with such assets, provided the debtor is already involved in main proceedings elsewhere (article 28).

C. Conflict of laws

13. The UNCITRAL Legislative Guide on Insolvency Law addresses some of the issues of conflict of laws that arise where insolvency proceedings involve parties or assets located in different States, noting that while insolvency proceedings may typically be governed by the law of the State in which those proceedings are commenced, many States have adopted exceptions to the application of that law.

14. Difficult problems of conflict of laws also arise with respect to multinational enterprises. One issue, for example, is that of parent company responsibility. The responsibility of a parent for a subsidiary might be determined by the law of the country in which the subsidiary is incorporated. That approach might not reflect the unity of the group as a whole as it would place creditors of the subsidiaries in unequal situations depending upon the location of the subsidiary. If, however, responsibility were to be based upon the rules of the jurisdiction of registration of the parent, that would lead to an extension of jurisdiction that might not be acceptable to other jurisdictions. This issue may be resolved to some extent where the parent voluntarily assumes the financial obligations of foreign subsidiaries, but not otherwise. The Working Group may wish to consider the extent to which conflict of laws issues should be addressed in future work on corporate groups and the steps that might be taken in that regard.

D. Provision of post-commencement finance

15. A/CN.9/WG.V/WP.74/Add.1 refers to the recognition in the Legislative Guide of the need to facilitate post-commencement finance in the domestic context. It also notes that many jurisdictions restrict the provision of new money in insolvency or do not specifically address the issue of new finance or the priority for its repayment in insolvency. Some of the structural impediments to providing new money include: lack of statutory authority; personal liability of an insolvency representative or directors or officers of the debtor for incurring the debts that such financing would entail; application of avoidance provisions to financing transactions; problems associated with providing priority to post-commencement finance; and a preference for liquidation over reorganization that makes the issue of such finance difficult to

⁵ UNCITRAL Legislative Guide, part two, chapter I, paras. 15-18.

address.⁶ The existence of these structural impediments with respect to domestic insolvency makes the availability and protection of post-commencement finance in cross-border insolvencies most uncertain. Differences exist between jurisdictions with respect to the priority accorded to post-commencement finance, as well as with respect to the provision of security for post-commencement finance. There are questions of applicable law, and of the use of post-commencement finance within corporate groups. For example, could post-commencement finance obtained by one insolvent corporate group member be used by another member of the same corporate group and if so, under what circumstances and conditions? Could a non-debtor member of a corporate group borrow money post-commencement and permit an insolvent group member to use those funds? In a number of cross-border insolvency cases, issues associated with post-commencement finance have been addressed in cross-border protocols.⁷

16. The recommendations of the Legislative Guide may not be sufficient to address post-commencement finance in the cross-border insolvency context. Some of the issues relevant to further consideration might include the following.

1. Authorization of post-commencement finance

17. The Legislative Guide refers to authorization by the court or consent by creditors (rec. 63) and in the domestic context it is clear which court and which creditors are relevant. In the insolvency of a corporate group, however, where the parent and subsidiaries may be located in different jurisdictions and thus be subject to different insolvency proceedings and different legal regimes, and finance may be required for one or more of those subsidiaries, several questions arise. Can the parent obtain finance in its own jurisdiction and provide it to the subsidiary in another jurisdiction? In that case, would court approval or creditor consent be required in the parent's jurisdiction or that of the subsidiary or perhaps both? Can one court approve post-commencement finance that will have effects in the other jurisdiction? Will both jurisdictions recognize orders made in the other affecting the provision of post-commencement finance in this situation?

18. The Legislative Guide notes that different laws require different types of authorization for different types of debt. For example, unsecured debt incurred by the insolvency representative in the ordinary course of business may not require authorization, while the same debt incurred outside the ordinary course will require authorization. Debt requiring security or priority will generally require authorization by the court and in some cases consent by creditors, especially where priority for post-commencement finance ranks ahead of existing priorities. In the cross-border context, should the requirement for authorization depend on the terms of the post-commencement finance?

19. The Legislative Guide also refers to post-commencement finance being obtained by the insolvency representative. In the type of scenario noted above, would it be the insolvency representative of the parent or the subsidiary? In

⁶ For a comparative summary and matrix of the treatment of post-commencement finance in 54 jurisdictions see International Insolvency Institute (<http://www.iiiglobal.org>); see also *Financing in Insolvency Proceedings*, INSOL 2006, which covers 12 countries: Australia, Brazil, Canada, Germany, Hong Kong, India, Japan, Netherlands, Poland, South Africa, UK and USA.

⁷ See *Digest of Financing Provisions from Cross-Border Insolvency Protocols*, International Insolvency Institute (<http://www.iiiglobal.org>).

addition, are there personal liability implications for the insolvency representative or for officers and directors of the parent or subsidiary?

2. Priority for post-commencement finance

20. The Legislative Guide recommends that an insolvency law should establish the priority to be accorded to post-commencement finance and that it should rank ahead of those claims of unsecured creditors with an administrative priority. In the cross-border context, which claims of which creditors will that priority refer to? How is the question of authorization affected by differences in the priority that may be afforded between the two jurisdictions?

3. Security for post-commencement finance

21. The Legislative Guide also refers to the provision of a security interest for post-commencement finance on unencumbered assets or already encumbered assets provided it does not have priority over existing creditors. It also recommends the procedure to be followed in order to provide a priority senior to that of existing secured creditors. Could the court of one jurisdiction approve post-commencement finance that involved encumbering property in another jurisdiction? Where existing secured creditors objected to the encumbrance of that property, could the court nevertheless approve the provision of a security interest and if so, under what circumstances?

4. Conversion of proceedings

22. Where reorganization proceedings are converted to liquidation, questions may arise as to whether the priority accorded to post-commencement finance in the reorganization will be recognized in a subsequent liquidation. The Legislative Guide recommends that it should be so recognized, but how would that issue be addressed in a cross-border situation?

E. Recognition of foreign proceedings

23. Outside those States to which the EC Regulation applies, achieving a coordinated result for the insolvency of one or more members of a corporate group located in different States depends upon whether foreign proceedings can be recognized and whether parties involved in the various proceedings can cooperate and coordinate with each other. In those States that have adopted the UNCITRAL Model Law on Cross-Border Insolvency,⁸ the answer should be relatively straightforward; proceedings commenced where the debtor has its COMI could be recognized as foreign main proceedings [art. 17], while proceedings commenced where the debtor has an establishment could be recognized as non-main proceedings. Once recognition has been ordered, specified assistance to the foreign proceedings comes into effect and the courts and insolvency representatives associated with the various proceedings are authorized to cooperate and communicate with each other. Where the Model Law has not been adopted,

⁸ Adopted in British Virgin Islands, overseas territory of the United Kingdom of Great Britain and Northern Ireland (2005), Eritrea, Great Britain (2006), Japan (2000), Mexico (2000), Montenegro (2002), Poland (2003), Romania (2003), Serbia (2004), South Africa (2000) and United States of America (2005).

however, reference must be had to national laws, many of which do not contain provisions equivalent to those provided in the Model Law with respect to recognition, assistance, cooperation or coordination.⁹ Because of the absence of such provisions, achieving a coordinated result can be time-consuming, costly and, in some cases, impossible.

24. For those reasons, coordination and harmonization of international insolvency proceedings has been greatly facilitated in recent years by practices and procedures developed by insolvency professionals and courts, starting with individual cases and the need to address particular issues faced by the parties. Agreements or “protocols” have been negotiated by the parties and approved by the courts in the jurisdictions involved. Those cross-border insolvency protocols cover a number of issues, including, for example, settling a particular dispute arising from the different laws in concurrent cross-border proceedings, creating a legal framework for the general conduct of the case and coordinating the administration of an insolvent estate in one State with an administration in another State. Some examples of cross-border protocols are discussed in UNCITRAL document A/CN.9/580, paragraphs 18-48.

25. At its 39th session in 2006, the Commission decided that work to compile practical experience with respect to negotiating and using cross-border insolvency protocols should be undertaken by the Secretariat, initially through informal consultation with judges and insolvency practitioners.¹⁰

F. Cooperation between courts and office holders

26. Chapter IV is a key part of the legislative framework provided by the Model Law, filling the gaps found in many national laws by expressly empowering courts to cooperate in the areas governed by the Model Law and to communicate directly with foreign counterparts. Notably, this is not restricted to the time after which a decision to recognize a foreign proceeding has been made, and it could therefore take place from the earliest point of contact. Authorization is also provided for cooperation between a court in the enacting State and a foreign representative, and between a person administering the insolvency proceeding in the enacting State and a foreign court or a foreign representative. Recognizing that the idea of cooperation might be unfamiliar to many judges and representatives, article 27 of the Model Law sets out possible means of cooperation. The analogous provision of the EC Regulation is article 31, which establishes a duty of cooperation and communication between, in the language of the Regulation, “liquidators”, but does not address the same obligation as between courts or between courts and liquidators. The key to many cross-border insolvency cases involving groups of companies has been the ability and willingness of courts and insolvency representatives to cooperate and communicate to ensure coordination of main and non-main proceedings.

⁹ For an analysis of the law of 39 jurisdictions, see “Cross-Border Insolvency: A Guide to Recognition and Enforcement”, INSOL International, 2003.

¹⁰ See *Official Records of the General Assembly, Sixty-first session, Supplement No. 17 (A/61/17)*, para. 209.

G. Where to from here?

27. In view of the current situation with respect to the insolvency of corporate groups internationally and in the absence of greater convergence of domestic insolvency laws, and in particular the rules addressing treatment of corporate groups, what can be done to facilitate the administration of cross-border insolvency cases, aside from promotion of the UNCITRAL Model Law, and is there a need for legislative provisions specifically addressing the insolvency of groups that might, for example, be added to the Model Law? The EC Regulation, which represents one mechanism that perhaps could be extended to specifically address questions relating to groups, applies directly to participating Member States to ensure that main proceedings commenced in one jurisdiction will be automatically recognized in other States, with certain specified effects. It entails a certain surrender of sovereignty within members States that facilitates its administration. Outside of an integrated regional group like the EU, however, a different approach may be required.

28. Consolidation and joint administration have been discussed above in the domestic context and may have application in cross-border cases. Other proposals are based upon establishing a concept of centre of main interests applicable to a corporate group that would facilitate group commencement and administration of insolvency proceedings.

1. Centre of main interests of a corporate group

29. One solution for addressing the issues noted above with respect to the cross-border treatment of groups might be to establish a concept of “centre of main interests of a corporate group”. This would be of particular relevance in cases where there was a high degree of integration between members of a corporate group and the group was run essentially as a single entity. The concept could be defined by reference to, for example, the issues discussed in the context of the COMI in the EU, such as how and where policy, management and financial decisions of the group were made (which has been referred to as where the “head office functions”¹¹ of the group were carried out) and third party perceptions, particular those of creditors, concerning that location. The COMI would determine the jurisdiction in which main insolvency proceedings against a corporate group or one or more of its members should be commenced and the law that would apply to commencement and administration of the proceedings. Where the adoption of such an approach depended on close integration of the group, the requisite level of integration would need to be defined. Creditors would be required to investigate the connections of a company with which they dealt to ascertain whether or not it was part of a group. It may lead to main insolvency proceedings being commenced against an insolvent subsidiary at the location of the group COMI, irrespective of whether the parent or other subsidiaries registered at that location were also subject to insolvency and local proceedings might still be required at the place of incorporation of the insolvent subsidiary to deal with its business and assets.

30. A different approach could be to deem the COMI of the group to be that of the parent corporation, so that all subsidiaries would also have that COMI and

¹¹ See Gabriel Moss, QC and Professor Dr. Christoph Paulus, *The urgent need for reform — what and when? Current trends in European Rescue and the Impact of the European Insolvency Regulation*, 15 July 2005.

jurisdiction for commencement of proceedings would not be related to place of incorporation or registered office.

2. Substantive consolidation

31. Where a group is closely integrated and assets and liabilities belonging to each group member cannot be easily identified, cross-border substantive consolidation might facilitate the administration of group proceedings. Consideration of this remedy in a cross-border case is, however, much more complex than in a domestic setting, since it raises issues of the insolvency law to apply; the extent to which courts could waive rules in a cross-border situation that would be applied in a domestic case; the avoidance rules to apply; negotiation, approval and implementation of a reorganization plan and so forth. Such consolidation in cross-border cases is not common. There are, however, examples of cases where the insolvency of a closely integrated group involving subsidiaries in different jurisdictions has been administered as if it were a single entity with the consent of creditors and the legality of the solution was never tested in the courts.¹² Some cases between Canada and the USA have involved a consolidated reorganization plan.

3. Joint administration

32. Another approach might be to adopt measures facilitating the broader use of joint administration. As noted above, few jurisdictions provide formally for joint administration of insolvency cases involving members of the same corporate group, although the practice does exist between some jurisdictions, for example, Canada and the United States.¹³ Joint administration requires no formal decision with respect to a group's centre of main interests and would be facilitated by adoption of the UNCITRAL Model Law, to provide a legislative framework for cross-border cooperation and communication, and the use of cross-border protocols or other mechanisms to address procedural and administrative issues between the different jurisdictions.

¹² *Bramalea* involved a corporation headquartered in Canada, with operating subsidiaries in Canada and the USA, as well as a number of partnerships and joint venture arrangements, discussed in Ziegel, J, *Corporate Groups and Crossborder Insolvencies: A Canada-United States Perspective*, 7 *Fordham J. Corp & Fin. L.* 367. There are additional examples of such an approach being used in the EU.

¹³ US law provides for companies related to an original applicant (where the relationship is defined) to file in the same court provided the original applicant has its domicile, residence, principal place of business or principal assets in the district of that court. Once the application has been made, the court may make an order for joint administration of the estate (US: Bankruptcy Code, title 28, 1408).

H. Issues for consideration: international treatment of corporate groups

33. A/CN.9/WG.V/WP.74/Add.1 raises a number of issues for consideration by the Working Group with respect to the treatment of corporate groups in insolvency in a domestic context. In addition to those issues, the Working Group may also wish to consider the following issues as they apply to the international context:

(a) Definition or description of a “corporate group” and the ways in which it might differ from the domestic context;

(b) Access to insolvency proceedings and in particular the jurisdiction in which single proceedings for a corporate group might be commenced by reference, for example, to some concept of COMI for corporate groups;

(c) The relief available in international proceedings, including joint administration and consolidation; and

(d) Provisions additional to those contained in the UNCITRAL Legislative Guide on Insolvency Law that might be required with regard to post-commencement finance.

**C. Report of the Working Group on Insolvency Law on the work of its
thirty-second session (New York, 14-18 May 2007)**

(A/CN.9/622) [Original: English]

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I. Introduction

1. At its thirty-ninth session, in 2006, the Commission agreed that the topic of the treatment of corporate groups in insolvency was sufficiently developed for referral to Working Group V (Insolvency Law) for consideration in 2006 and that the Working Group should be given the flexibility to make appropriate recommendations to the Commission regarding the scope of its future work and the form it should take, depending upon the substance of the proposed solutions to the problems the Working Group would identify under that topic.

2. At its thirty-first session, held in Vienna from 11 to 15 December 2006, the Working Group agreed that its current discussion of the treatment of corporate groups in insolvency suggested the need for further work; that the UNCITRAL Legislative Guide on Insolvency Law and the UNCITRAL Model Law on Cross Border Insolvency provided a sound basis for the unification of insolvency law; and that the integrity of those texts should be maintained in any future work. It was also agreed that the current work was intended to complement those texts, not to replace them (see A/CN.9/618, paragraph 69).

3. On that occasion, it was suggested that a possible method of work would entail the consideration of the provisions contained in these existing texts that might be relevant in the context of corporate groups and the identification of those issues that required additional discussion and the preparation of additional recommendations. Other issues, although relevant to corporate groups, could be treated in the same manner as in the Legislative Guide and Model Law. It was also suggested that the possible outcome of that work might be in the form of legislative recommendations supported by a discussion of the underlying policy considerations (see A/CN.9/618, paragraph 70).

II. Organization of the session

4. Working Group V (Insolvency Law), which was composed of all States members of the Commission, held its thirty-second session in New York from 14 to 18 May 2007. The session was attended by representatives of the following States members of the Working Group: Canada, Chile, China, Colombia, Croatia, Fiji, France, Germany, Guatemala, India, Iran (Islamic Republic of), Italy, Jordan, Kenya, Lithuania, Madagascar, Mexico, Morocco, Nigeria, Pakistan, Poland, Qatar, Republic of Korea, Russian Federation, Spain, Sweden, Switzerland, Thailand,

Tunisia, Turkey, Uganda, United Kingdom of Great Britain and Northern Ireland, United States of America, Venezuela (Bolivarian Republic of) and Zimbabwe.

5. The session was also attended by observers from the following States: Denmark, Egypt, El Salvador, Holy See, Ireland, Malaysia, Netherlands, Philippines, Romania, Senegal, Slovenia, Sudan and Yemen.

6. The session was also attended by observers from the following international organizations:

(a) **Organizations of the United Nations system:** International Monetary Fund (IMF) and the World Bank;

(b) **Intergovernmental organizations:** Asian-African Legal Consultative Organization (AALCO), Asian Development Bank (ADB), European Central Bank (ECB) and the European Commission (EC);

(c) **International non-governmental organizations invited by the Working Group:** American Bar Association (ABA), INSOL International, International Bar Association (IBA), International Insolvency Institute (III) and International Women's Insolvency & Restructuring Confederation (IWIRC).

7. The Working Group elected the following officers:

Chairman: Mr. Carlos Sánchez Mejorada y Velasco (Mexico)

Rapporteur: Mr. Adam Ożarowski (Poland)

8. The Working Group had before it the following documents:

(a) Annotated provisional agenda (A/CN.9/WG.V/WP.75);

(b) A note by the secretariat on the treatment of corporate groups in insolvency (A/CN.9/WG.V/WP.76 and Add.1 and 2).

9. The Working Group adopted the following agenda:

1. Opening of the session;
2. Election of officers;
3. Adoption of the agenda;
4. Consideration of the treatment of corporate groups in insolvency;
5. Other business;
6. Adoption of the report.

III. Deliberations and decisions

10. The Working Group began discussion of the treatment of corporate groups in insolvency on the basis of documents A/CN.9/WG.V/WP.76 and Add.1 and 2, and other documents referred therein. The deliberations and decisions of the Working Group on this topic are reflected in section IV below.

IV. Treatment of corporate groups in insolvency

11. The Working Group commenced its deliberations with general observations on the form that the work on corporate groups might take. It was emphasized that the work should build upon the UNCITRAL Legislative Guide on Insolvency Law and the UNCITRAL Model Law on Cross-Border Insolvency without unnecessarily restating those texts and adding additional material only where supported by the Working Group. It was suggested that any decision on the form of the work should be taken at a later stage to fully reflect the outcome of the Working Group's deliberations.

A. Glossary: definition of corporate group

12. The Working Group considered the definition of "domestic corporate group" and "international corporate group" as set forth in paragraph 3 of document A/CN.9/WG.V/WP.76. Some concerns were expressed with respect to the generality of the definition proposed and the consistency of the use of that definition throughout the document. Concerns were also expressed with respect to the contractual element of the definition. It was agreed that further refinement of the definition should take place after deliberations on the substantive issues, with the existing definition sufficing as a preliminary and provisional working basis for those deliberations (see paragraphs 77-84 below).

B. The onset of insolvency: domestic issues

1. Commencement of proceedings

Debtor application for commencement

13. Concerns were expressed on various aspects of the commencement of insolvency proceedings, including the question of solvent entities being the subject of applications for commencement of insolvency proceedings; the extent of creditor applications and, in particular, the ability of a creditor to apply for commencement of insolvency proceedings with respect to a group member, of which it was not a creditor or to a solvent member of which it was a creditor; and the scope of requirements for the giving of notice in a group context, particularly with respect to members of a group that were not the subject of an application for commencement. It was also suggested that the need to differentiate between liquidation and reorganization in the case where applications for both were made against members of a group should also be considered.

Recommendations 1-4

14. Those concerns, in so far as they related to solvent members of a group were also expressed with respect to draft recommendations 1-4 and in particular, the extent to which those recommendations indicated a departure from recommendations 15 and 16 of the Legislative Guide by allowing an application to include a solvent member of a group. It was agreed that such a possibility raised serious concerns for the stakeholders of the solvent group member, including lenders, creditors and shareholders, as well as issues of unfair competition. A further concern related to issues of jurisdiction and determination of the court competent to

consider the proposed joint application. The prevailing view was that draft recommendations 1-4 could not be supported in the suggested draft form, although the view was also expressed that they could provide the basis for further discussion (see paragraphs 19 and 20 below).

15. To focus on the complexity of the different questions raised by the proposal for joint applications, the Working Group agreed to an approach that would examine the issues layer by layer, starting with the simplest hypothetical case. Such an approach would facilitate a clear definition and understanding of the issues at stake at each stage of the insolvency process, both in a domestic context and internationally, and the acceptability of possible solutions.

16. The first example considered was that of two or more members of a corporate group both meeting the commencement standard of recommendation 15 of the Legislative Guide and located in the same jurisdiction. It was generally agreed that those two members should be permitted to apply together for commencement of proceedings. It was added that such an application would not affect the separate identity of the applicants. Where the two members were situated in different jurisdictions, reference would be made to the relevant treatment of jurisdictional issues in the Legislative Guide and to domestic law.

17. The second example raised the question of an application that included a solvent member of the group. It was agreed that that example was much more complex, touching upon the relationship between the solvent and insolvent members, including financial arrangements, management and so forth, as well as the terms of recommendation 15 of the Legislative Guide. With respect to the latter, it was noted that since paragraph (a) of recommendation 15 included the possibility of imminent insolvency, it would also apply in the corporate group context. If, for example, the insolvency of the parent of the group was likely to cause the financial failure of other members of the group, that situation would potentially be covered by recommendation 15.

18. It was pointed out that, as previously discussed, the possibility of including solvent entities in reorganization under the protection of the insolvency law raised fundamental issues of unfair competition and could not be supported. In addition, such an approach would have a direct impact on the provision of finance and credit based upon the separate identity of individual business entities. It was further suggested that a distinction needed to be drawn between including a solvent entity in an application for commencement of proceedings and extending proceedings already commenced to additional entities on the basis of a thorough investigation that could include the views of relevant stakeholders and would involve the application of relevant safeguards under insolvency law. While the former could not be supported, the latter possibility would need to be considered at a later stage.

19. On that basis, some support was expressed in favour of considering the substance of draft recommendation 3 of A/CN.9/WG.V/WP.76 in the context of commencement of insolvency proceedings, rather than in the context of an application for commencement, as the conditions specified would be relevant to determining whether, for example, the proceedings should be jointly administered.

20. After further discussion, the prevailing view was that draft recommendation 1 should be retained and draft recommendations 2-4 deleted, noting the potential relevance of the conditions set forth in draft recommendation 3 to the discussion of joint administration.

Creditor application for commencement

21. On the question of a creditor application for commencement of insolvency proceedings, the Working Group considered whether a creditor could make a joint application against two or more insolvent group members of which it was a creditor. The view that that situation was adequately covered by recommendation 16 of the Legislative Guide received some support. However, there was also support for the view that a recommendation to that effect might be useful, and the secretariat was requested to prepare a draft for future consideration by the Working Group.

Debtor application: notice to creditors

22. With respect to draft recommendation 5, there was support for deleting the words in the second set of square brackets, on the basis that such a requirement was too onerous. Different views expressed were that it would be useful for all creditors of the group to be aware of the commencement of insolvency proceedings and that due process required that all parties whose interests were likely to be affected by the commencement of insolvency proceedings should be informed. It was recalled that recommendations 22-25 of the Legislative Guide addressed several issues relevant to the provision and content of notice on commencement of insolvency proceedings and that those recommendations would apply equally in the corporate group context. As a general matter of drafting, it was suggested that while it would not be necessary to restate the content of the recommendations of the Legislative Guide in this work, it would nevertheless be useful to clearly indicate the connection between this work and the relevant recommendations of the Legislative Guide and clarify that the draft recommendations of this work built upon those of the Legislative Guide. The connection between draft recommendation 5 and recommendation 24 of the Legislative Guide was questioned, especially in the light of the proposal to delete the words in the second set of square brackets. It was observed that while recommendation 24 addressed notification of creditors of the debtor, draft recommendation 5 went further and required creditors of one group member to be given notice of the proceedings commenced against another group member. After discussion, it was agreed that draft recommendation 5 should be retained with deletion of the words as noted above.

23. Support was expressed in favour of retaining draft recommendation 6, with further consideration to be given to its placement in relation to other draft recommendations addressing joint administration.

Creditor application: notice to the debtor

24. It was agreed that draft recommendation 7 should be retained, but that the words “[all members of the corporate group]” should be deleted on the same basis as the deletion of similar words from draft recommendation 5 was agreed.

Joint administration

25. It was noted that since draft recommendation 8 addressed the issue of joint administration it should be discussed in the context of the treatment of assets on commencement of insolvency proceedings.

2. Treatment of assets on commencement of insolvency proceedings

(a) Joint administration and appointment of an insolvency representative

26. The Working Group discussed joint administration and appointment of an insolvency representative on the basis of the considerations set forth in paragraphs 32 and following of document A/CN.9/WG.V/WP.76.

Definition of joint administration

27. It was suggested that the definition of joint administration contained in document A/CN.9/WG.V/WP.74, part I, letter (j) needed further refining. In particular, it was indicated that in the context of corporate groups joint administration could refer to varying levels of integration of proceedings, namely:

(a) Coordination of two or more separate insolvency proceedings regarding members of the same corporate group, each having its own insolvency representative;

(b) Appointment of a single insolvency representative in two or more separate insolvency proceedings regarding members of the same corporate group;

(c) Appointment of a single insolvency representative in single insolvency proceedings regarding two or more members of the same corporate group; and

(d) Pooling of assets and liabilities of two or more members of the same corporate group (substantive consolidation).

28. It was indicated that the purpose of joint administration was to promote cost efficiency and procedural convenience, for instance, through knowledge sharing and preservation of the integrity of the various economic units of the corporate group. Examples of those benefits could be found, for instance, in the possibility of streamlining notice formalities and of holding joint creditors' meetings. It was stressed that the effect of joint administration should be limited to administrative aspects of the proceedings and should not touch upon substantive issues. It was further suggested that joint administration should not prevent the possibility of returning to separate administration of each insolvency proceeding at a later stage.

29. Concerns were expressed with respect to the possibility that joint administration might interfere with rules on jurisdiction in those cases where, under those rules, different courts would have competence over the various members of the corporate group. In response, it was indicated that domestic procedural law might effectively deal with the matter. It was agreed that jurisdictional issues should be considered at a later stage of the work, possibly in conjunction with the discussion of the centre of main interests.

30. The Working Group agreed that, in light of the intended goals, it was desirable that a definition of joint administration should encompass the cases outlined in (a) and (b) of paragraph 27 above. It was further agreed that the cases outlined in (c) and (d) of paragraph 27 above went beyond an acceptable notion of joint administration.

31. It was suggested that joint administration should be permitted both in the case of a joint application by two or more members of the same corporate group and in the case of multiple separate applications. It was added that joint administration should be granted exclusively at the discretion of the court.

Recommendations 8, 9, 10 and 11

32. The Working Group agreed that draft recommendation 8 was acceptable in light of the definition of joint administration and of the additional explanations referred to above. The secretariat was requested to revise the material on joint administration in the light of that discussion. It was also suggested that the bracketed words “in the same court” should be substituted with the words “in different courts or in the same court” to ensure that joint administration would be permitted in both cases.

33. It was suggested that the term “should” be replaced by the term “may” in draft recommendation 9.

34. It was also suggested that draft recommendation 10 should permit the appointment of one or more additional insolvency representatives, in appropriate circumstances.

35. Support was indicated for the inclusion in draft recommendation 11 of practical examples of the manner in which cooperation to the maximum extent could be achieved, along the lines of the examples offered in paragraph 36 of document A/CN.9/WG.V/WP.76.

(b) Application of the stay: recommendation 12

36. In the light of the Working Group decision that solvent group members could not be included in insolvency proceedings, it was suggested that draft recommendation 12 was not appropriate. It was added that it would negatively affect the interests of creditors of the solvent group member. It was also pointed out that membership of a corporate group of which some members were insolvent was not a sufficient basis for such relief to be ordered with respect to a solvent member of the same group and that the availability of such relief would negatively affect access to credit for solvent members of a corporate group and would also raise issues of unfair competition. A different view was that in certain limited circumstances, such as to protect an intra-group guarantee as mentioned in paragraph 31 of document A/CN.9/618, the relief provided in draft recommendation 12 should be available at the discretion of the court. After discussion, it was agreed that draft recommendation 12 should be deleted.

(c) Use and disposal of assets

37. The Working Group considered the question posed in paragraph 53 of document A/CN.9/WG.V/WP.76 concerning the use of assets of a solvent member of a group to support the reorganization of insolvent members.

38. It was noted that although recommendation 54 of the Legislative Guide addressed the use of third-party-owned assets, the reference to a third party would usually be understood as being to a party external to the group. Accordingly, it was suggested that it might be useful, in the corporate group context, to address the situation of a special purpose entity (see A/CN.9/WG.V/WP.74, paragraphs 17-19) established for the purpose of holding assets such as intellectual property that were key to the continuation of the activities of the insolvent entities. It was recalled that the Working Group had discussed that matter at its previous session (A/CN.9/618, paragraph 33), and the concerns expressed at that time were reiterated. The view that no recommendation was required to address the issue received support. It was also suggested, however, that the question of the use of those assets might be

addressed in the context of a reorganization plan and it was agreed that the issue should be further considered in that context.

(d) Post-commencement finance: recommendations 13-19

39. The Working Group emphasized the importance of post-commencement finance to both liquidation, especially in the case of sale as a going concern, and reorganization, and the desirability of including recommendations on the issue to provide information and guidance to those States not familiar with the issue.

40. It was noted that, in the corporate group context, the question of post-commencement finance raised a number of issues that were different to those relating to a single entity, including: in the situation of a single insolvency representative for several members of the group, the possibility of conflict of interest between the needs of the different debtors with respect to ongoing finance; the involvement of solvent members of the group, especially in cases where that member was controlled by the insolvent parent of the group; the use of the assets of a solvent special purpose entity with a single creditor for the purposes of obtaining finance for other insolvent members of the group; balancing the interests of individual members of the corporate group with the reorganization of the group; and the desirability of maintaining, in insolvency proceedings, the financing structure that the group had before the onset of insolvency, especially where that structure involved pledging all of the assets of the group for finance that was channelled through a centralized group entity with treasury functions.

Recommendation 13

41. The view was expressed that since a corporate group did not have legal identity as such, draft recommendation 13 should only refer to the provision of post-commencement to individual members of the group, but not to the corporate group itself. With that revision, the substance of draft recommendation 13 was supported.

Recommendation 14

42. It was noted that draft recommendation 14 was based upon recommendation 63 of the Legislative Guide, with the addition of the alternative texts in square brackets and the specific references to members of a corporate group. It was suggested that the decision on draft recommendation 13 with respect to the references to the group should be reflected in the drafting of recommendation 14. To that end, it was proposed that the language in the first set of square brackets should be deleted and the alternative text retained; that the words following “survival of the business” in the first sentence should be “of that member”; and that the second sentence should refer to the provision of post-commencement finance “for any member of the group”. After discussion, those proposals were supported.

43. Several additional proposals were made with respect to the words “the preservation or enhancement of the value of the estates of one or more members of the group” including: that the reference should be to the value of the corporate group as a whole since the group may have more value than the sum of the members taken separately; that the reference should be limited to the member receiving the post-commencement finance; and that it should be cumulative, referring to both preservation and enhancement of value. After discussion, it was agreed that the text should be retained as drafted.

44. It was also proposed that draft recommendation 14 should be revised to take into account the general agreement of the Working Group that restatement of the recommendations of the Legislative Guide should be avoided and the elements specific to the corporate group context that required addition to or departure from the provisions of the Legislative Guide should be clearly indicated.

45. With respect to the powers of the insolvency representative to obtain post-commencement finance, the view was expressed that, contrary to the language of draft recommendation 14, that power should not be unfettered, in particular because of the potential for conflict of interest in the case of a single insolvency representative in a joint administration of multiple insolvency proceedings. On that basis, it was suggested that approval of the court or of creditors referred to in the second sentence should be a requirement of the insolvency law. A different view was that, as the insolvency representative would be subject to specific duties and liability for actions taken, there was no need to circumscribe the ability of the insolvency representative to obtain post-commencement finance by requiring court or creditor approval. After discussion, the prevailing view was that the second sentence of draft recommendation 14 should be retained as drafted.

46. After discussion, the Working Group agreed to the substance of draft recommendation 14, with the drafting suggestions noted above.

Recommendation 15

47. A number of clarifications were sought as to the meaning of draft recommendation 15 and in particular the phrase “debtor-guarantor” and the tests included in paragraphs (a)-(c), in so far as they referred to concepts such as comparable benefit and economic harm.

48. The question was also raised as to which creditors were referred to in paragraph (b): it was suggested that if the reference was to all creditors, the proposed requirement of seeking consent might prove not only unworkable, but also costly.

49. It was proposed that the requirements contained in paragraphs (a)-(c) should be cumulative rather than alternative in order to ensure the appropriate level of protection. In response, it was suggested that to do so would set a standard so high that it could almost never be met and would defeat the purpose of facilitating post-commencement finance. It was observed that the provision of guarantees in a corporate group context was a common mechanism for financing and what needed to be considered was how that normal practice was affected by the onset of insolvency and the safeguards that were required.

50. In discussing the possible scope of draft recommendation 15, the Working Group considered separately the questions of whether an insolvent group member could provide a guarantee to another insolvent group member and whether a solvent group member could provide a guarantee to an insolvent group member.

51. With respect to the first question, it was observed that that might be prohibited in some States as constituting, for example, a preferential transaction. It was also pointed out that in the context of a single insolvency representative administering multiple insolvency proceedings, a conflict of interest was likely to arise with respect to the provision of such a guarantee.

52. With respect to the second question, it was indicated that to permit such a guarantee to be given would amount to a transfer of the assets of that solvent entity

to the insolvent entity to the detriment of the creditors and shareholders of the solvent entity, and in the context of joint administration would raise a potential conflict of interest. Such an approach could not be supported. In response, it was pointed out that the solvent entity would be acting on its own authority under company law in a commercial context and should not be required to seek additional authority from its creditors to provide financial support to another member of the group if management so wished. It was also suggested that different types of solvent entities, such as special purpose entities with few liabilities and many assets, could be involved in providing such a guarantee; that the solvent group member might have an interest in the financial stability of the parent or of other members of the group, depending upon the specific circumstances; and that the interests of the group as a whole might be a consideration. In the specific context of draft recommendation 15, it was noted that the court was required to assess whether the various safeguards set forth in paragraphs (a)-(c) were met before the guarantee could be provided.

53. It was proposed that many of the difficulties associated with the question might be solved if addressed in the context of a reorganization plan, in which the solvent group member, as well as finance providers, could participate on a contractual basis. While acknowledging that there might be situations where that approach could be appropriate, it was pointed out that very often post-commencement finance was required at any early stage of the insolvency proceedings and before a plan could be negotiated. A further observation was that post-commencement finance might also be required in situations, such as liquidation on a going concern basis, where there would not be a reorganization plan.

54. The Working Group requested the secretariat to reconsider and revise draft recommendation 15 for future consideration, taking into account the different issues raised in the discussion and the need to provide greater clarity with respect to the various elements.

Recommendation 16

55. The Working Group agreed to the substance of draft recommendation 16 with the following revisions: deletion of the reference to a corporate group in the first set of square brackets and amendment of the reference to the ordinary unsecured creditors of “each” member of the group to “that” member of the group.

Recommendation 17

56. The Working Group agreed to the substance of draft recommendation 17 with the following revision: “provided to the group [or member of the group]” substituted with “provided to another member of the group”.

Recommendation 18

57. It was agreed that the two texts in square brackets should be retained with the square brackets removed. A further suggestion was to clarify which secured creditors were concerned by adding the word “affected” to the words “existing secured creditors”. With respect to the alternative at the end of the draft recommendation permitting either consent of the existing secured creditors or adherence to the procedure in draft recommendation 19, the view was expressed that only the consent of the existing creditors should be required. It was observed that to proceed without that approval might raise constitutional issues and constituted a

“cram-down”, which might be acceptable only in exceptional cases such as where a creditor unreasonably withheld its consent. Another view was that draft recommendation 18 had to be considered together with draft recommendation 19, which provided the necessary safeguards to existing secured creditors.

58. After discussion, the substance of draft recommendation 18 was approved with the revisions noted above.

Recommendation 19

59. The Working Group agreed to the substance of draft recommendation 19 with the deletion of the second alternative text in square brackets in paragraph (b) and removal of the square brackets from the first alternative.

60. It was noted that the headings of recommendations 13-19 would need to be revised to reflect the agreements on the substance of each recommendation.

(e) Avoidance: recommendations 20-21

61. At the outset of the discussion, several observations of a general nature were made concerning issues underlying the concepts being discussed. Those included: the question of how a creditor could identify that it was dealing with a member of a corporate group, noting that that question would be of particular importance if the rules applicable to the corporate group context were different to those applicable to single corporate entities; the need for clearer definition of what constituted a corporate group, as well as other concepts and assumptions; and the need to clarify whether the work proceeded from an assumption of corporate separateness and an identification of the circumstances, if any, that might justify a departure from that assumption. The Working Group agreed that those issues needed to be considered.

62. With respect to avoidance, it was recalled that the Legislative Guide addressed that issue in some detail, both in the commentary and the recommendations (part two, chapter II, paragraphs 148-203). The recommendations with respect to related person transactions, however, addressed only the issue of the suspect period (recommendation 90) and the need for specification of the categories of persons to be treated as persons related to the debtor (recommendation 91). The issue for consideration by the Working Group, it was suggested, was whether further treatment was required to address transactions occurring in the group context.

63. A number of questions were raised with respect to the goal of avoidance in the corporate group context, noting that the involvement of parties both internal and external to the group in transactions that might be subject to scrutiny suggested the need to consider whether treatment different to that of the Legislative Guide was required. In particular, it was questioned whether the desired goal should be protection of intra-group transactions based upon the notion of a corporate group as a whole or particular scrutiny of those transactions on the basis that each group member was a separate entity and transactions between them should be considered as related person transactions, within the meaning of the definition of that term in the Legislative Guide (Glossary, paragraph (jj)). Some support was expressed in favour of the latter approach.

64. Support was also expressed in favour of the approach adopted in draft recommendations 20 and 21, which was to draw attention to the fact that transactions occurring in the group context raised special considerations that might need to be addressed in the insolvency law. It was suggested that the possibility of

fraud should be included as a basis for avoiding transactions occurring in the group context.

65. After discussion, the substance of draft recommendations 20 and 21, with the addition of a reference to fraudulent transactions, was approved.

(f) Subordination

66. The Working Group considered the question raised in paragraph 17 of document A/CN.9/WG.V/WP.76/Add.1. Limited support was expressed in favour of the need to address the issue of subordination by way of recommendation.

3. Remedies

Consolidation: recommendation 22

67. The Working Group emphasized that consolidation should be available as a remedy only in very limited and appropriate circumstances and that that approach should be clearly reflected in draft recommendation 22.

68. It was observed that the criteria indicated in paragraphs (a)-(c) of the draft recommendation would generally become apparent only after the commencement of insolvency proceedings and that that point should be more clearly reflected in the drafting.

69. It was suggested that paragraph (a) of draft recommendation 22 might also include a reference to intermingled debts.

70. Some concern was expressed as to the scope of paragraph (b) and the difficulties associated with ascertaining what was in the mind of creditors at the time they entered into transactions with members of a corporate group, as noted in paragraph 27 of A/CN.9/WG.V/WP.76/Add.1. For that reason, it was suggested that the test in paragraph (b) should refer to a majority or significant number of creditors.

71. A further suggestion was that the criterion of benefit to all creditors set forth in paragraph (c) should be regarded as the key factor in ordering consolidation and, as such, would resolve any potential ambiguity in draft paragraph (b). To indicate the significance of that factor, it was agreed that reference to that criterion should be moved from paragraph (c) to the chapeau of the recommendation and that paragraph (c) should be deleted accordingly.

72. It was agreed that a further factor to be considered in ordering consolidation would be the existence of fraudulent schemes or fictitious structures, which should be added as paragraph (d).

73. The substance of draft recommendation 22 was approved with the drafting revisions noted above.

4. Reorganization

Unified reorganization plan: recommendations 23-24

74. With respect to draft recommendation 23, it was proposed that the reference to “proposal” of the plan should be revised to “approval” of the plan; that it should be made clear in the draft recommendation that such a plan would recognize the interests and rights of the creditors of the different group members included in the

plan; and that it might be more appropriate to refer to a “joint plan” rather than to a “unified plan”. The substance of the draft recommendation was approved with those revisions.

75. With respect to draft recommendation 24, the view that a solvent entity could not be included in a reorganization plan by order of the court, because it was not subject to the insolvency law and not part of the insolvency proceedings, was widely supported. Nevertheless, recognizing that there would be circumstances in which such inclusion was appropriate and that it was not unusual in practice, the Working Group agreed that a solvent entity could be included in a reorganization plan on a voluntary basis in order to aid the reorganization of other members of the same corporate group, provided the shareholders and creditors of that solvent entity agreed in accordance with applicable corporate rules. The secretariat was requested to draft a new recommendation to that effect for future consideration.

5. Other issues

76. The Working Group deferred its consideration of the issues raised in paragraph 49 of document A/CN.9/WG.V/WP.76/Add.1 to a future session.

6. Definition of “corporate group”

77. The Working Group discussed a possible definition of “corporate group” in the context of insolvency proceedings on the basis of the text provided in paragraph 3 of document A/CN.9/WG.V/WP.76, as well as of the considerations expressed in paragraphs 7 and following of document A/CN.9/WG.V/WP.74.

78. It was indicated that a number of definitions of corporate groups existed in different areas such as tax, accounting and stock exchange regulations. It was further indicated that such a definition existed also in certain insolvency laws, such as, for instance, Colombia, where that definition was built around the two key ideas of unity of purpose and of unity of decision-making of the members of the corporate group.

79. A concern with respect to the concept of “corporate group” as set forth in paragraph 3 of document A/CN.9/WG.V/WP.76 was the need for third parties to be able to identify their commercial partners as members of a group. As noted above with regard to consolidation, it was indicated that determining the level of awareness of third parties about the existence of the corporate group might entail difficulties. It was added that establishing such a requirement might require a publicity or registration system, and that such a system might not be easy to administer at the cross-border level and would potentially require sanctions for non-compliance.

80. It was suggested that a possible definition of “corporate group” should be built on the basis of certain core elements common to all jurisdictions. Those core elements could be identified in: plurality of enterprises having assets in different jurisdictions; control over the members of the corporate group expressed in the unity of its managerial direction; and actual exercise of that control. It was added that other elements, such as publicity of the membership of a corporate group and third parties’ awareness of the existence of the group, could be added for consideration by individual States.

81. It was further indicated that the Working Group might wish to consider different notions of “corporate group” depending on the context and the scope of the

relevant provision. For instance, it was explained that a broad notion of corporate group might be desirable for the purpose of joint administration and a narrow definition for avoidance.

82. With respect to the definition contained in paragraph 3 of document A/CN.9/WG.V/WP.76, it was observed that the reference to unincorporated enterprises was necessary as those enterprises were subject to insolvency proceedings in a number of States. It was added that that approach was in line with recommendation 8 of the Legislative Guide. Similar remarks were made with respect to the inclusion of a reference to natural persons in that definition.

83. It was further suggested that, while the reference to contractual arrangements in the draft definition of “corporate group” should be maintained, those contracts, such as franchising agreements, which did not entail any control between contract parties, should be excluded.

84. After discussion, the Working Group requested the Secretariat to prepare a new draft definition of “corporate group” in light of the comments expressed above.

C. International issues

1. Jurisdiction to commence insolvency proceedings: centre of main interests (COMI)

85. The Working Group deferred its discussion of the topic of jurisdiction on the commencement of insolvency proceedings to a future session.

2. Treatment of assets on commencement of insolvency proceedings

(a) Joint administration

86. The Working Group agreed to discuss joint administration of insolvency proceedings in the international context at a later session, in conjunction with consideration of the revised recommendations on joint administration in the domestic context.

(b) Post-commencement finance: recommendations 25-33

87. With respect to post-commencement finance, the Working Group noted that some of the revisions agreed with respect to the recommendations on post-commencement finance in the domestic context (see paragraphs 39-60 above), such as the references to the corporate group obtaining such finance, would need to be reflected also in recommendations 25-33, since it would be desirable to have the same rules in both contexts.

88. It was noted, however, that a number of issues arising in the international context did not apply domestically, in particular the issue raised by draft recommendation 27 and the transfer of value between members of the corporate group. It was added that those issues might require the adoption of an approach different from that taken in the domestic context. It was suggested, for example, that the movement of assets in the group context might be governed by economic considerations that would lead to the adoption of a more flexible approach and to a greater willingness to permit those transfers. It was also suggested that the need for greater flexibility should be reflected in the draft text.

89. It was further observed that the recommendations should focus upon the conditions under which post-commencement finance might be available.

90. Concern was expressed with respect to draft recommendation 26 on the basis that it was not clear from the current draft which insolvency representative would be in a position to obtain finance in a corporate group context and on behalf of which entity that finance would be obtained. It was noted in response that the answer to that question might depend upon whether there was a joint administration of the group members or individual insolvency proceedings of those members, each with a distinct insolvency representative.

91. After some preliminary discussion, the Working Group agreed that further discussion of those recommendations should take place at a later session when the revised recommendations on post-commencement finance in the domestic context could be further considered.

3. Remedies: substantive consolidation

4. Reorganization: unified reorganization plans

5. Other issues: conflict of laws

92. The Working Group noted that issues relating to substantive consolidation, unified reorganization plans and conflict of laws raised a number of complex questions in the international context and deferred their consideration to a later session after further discussion of those issues in the domestic context.

D. Form of future work

93. The Working Group agreed that at this stage a decision on the form of its work was not possible. It was generally agreed that the Legislative Guide should form the starting point for that work, and that the issues raised by the treatment of corporate groups in insolvency should be carefully analysed and specific provisions should be developed where required for that context.

94. It was further agreed that working papers in the format of A/CN.9/WG.V/WP.76 and its addenda facilitated the deliberations of the Working Group on the various issues relating to treatment of corporate groups in insolvency, and that that approach should be continued.

**D. Note by the Secretariat on the treatment of corporate groups in insolvency,
submitted to the Working Group on Insolvency Law at its thirty-second session**

(A/CN.9/WG.V/WP.76 and Add.1-2) [Original: English]

A/CN.9/WG.V/WP.76

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1. This note draws upon the material contained in A/CN.9/WG.V/WP.74 and Add.1 and 2, the UNCITRAL Legislative Guide on Insolvency Law (the Legislative Guide), the UNCITRAL Model Law on Cross-Border Insolvency (the Model Law), and the Report of Working Group V (Insolvency Law) on the work of its thirty-first session (A/CN.9/618). It has been prepared on the basis that the work on corporate groups will form a supplement to the Legislative Guide and therefore follows the format of the Legislative Guide, including both commentary and recommendations. Some explanatory notes on recommendations have also been included, but only for the information of the Working Group.

I. Glossary

2. A glossary of terms relating to corporate groups is included in A/CN.9/WG.V/WP.74. The Working Group may wish to consider which of the explanations for a particular term contained in the Glossary in A/CN.9/WG.V/WP.74 would be the most appropriate for the purposes of revising the Glossary, along the lines of the Glossary contained in the Legislative Guide.

3. Additional terms could include the following:

(a) Domestic corporate group

A number of enterprises, including enterprises that are not necessarily incorporated, that: (a) are [associated by common or interlocking holdings or allied by control, including the capacity to control] [bound together by means of capital or control, including capacity to control]; and (b) organize and conduct their business in a coordinated manner. The capacity to control includes corporate groups based on a contractual arrangement.

(b) International corporate group

A number of enterprises, including enterprises that are not necessarily incorporated, that: (a) are subject, whether through incorporation, the conduct of economic activity, the presence of assets or some other test, to the legislation of different countries; (b) are [associated by common or interlocking holdings or allied by control, including the capacity to control] [bound together by means of capital or control, including capacity to control]; and (c) organize and conduct their business in a coordinated manner.

II. Background

4. The Working Group may wish to consider whether the background material contained in document A/CN.9/WG.V/WP.74, which discusses the nature of corporate groups, reasons for conducting business through corporate groups, definition of the “corporate group” and regulation of corporate groups, could be expanded to reflect additional comparative material based on the practice of different jurisdictions and form the basis of a background chapter for the work to be developed on corporate groups.

III. The onset of insolvency: domestic issues

A. Commencement of proceedings

1. Commencement standards

[Reference: Legislative Guide: part two, chap. I, paras. 20-79 and recommendations 14-29]

5. The standard to be met for commencement of insolvency proceedings is central to the design of an insolvency law. As the basis for insolvency proceedings, that standard is instrumental to identifying the debtors that can be brought within the protective and disciplinary mechanisms of the insolvency law and determining

who may make an application for commencement, whether the debtor, creditors or other parties. It will also affect the type of proceedings that can be brought against a debtor.

6. The Legislative Guide discusses issues relating to commencement of insolvency proceedings in some detail.¹ In general, the considerations identified as applying to commencement against a single debtor will apply in the corporate context, although some additional issues are raised below.

7. Many insolvency laws require a debtor to be insolvent (however defined) for commencement of insolvency proceedings. As a general rule, insolvency laws also respect the separate legal status of each member of a corporate group and a separate application for commencement of insolvency proceedings would therefore be required for each member of the group that satisfied the insolvency test. In that context, one issue of relevance to determining which members of a corporate group satisfy the test of insolvency is how various liabilities such as intra-group indebtedness and potential liabilities under a cross guarantee should be treated.

8. A second key issue in the treatment of corporate groups in insolvency is the degree to which the corporate group is economically and organizationally integrated and how that level of integration affects treatment of the group in insolvency and in particular, the extent to which a highly integrated group should be treated differently to a group where individual members retain a high degree of independence. In some cases, where for example the structure of a group is diverse, involving unrelated businesses and assets, the insolvency of one or more members of the group may not affect other members or the group as a whole and the insolvent members can be administered separately. In other cases, however, the insolvency of one member of a group may cause financial distress in other members or in the group as a whole, because of the group's integrated structure, with a high degree of interdependence and linked assets and debts between its different parts.

2. Persons permitted to apply

9. As a matter of general insolvency law, the Legislative Guide recommends that creditors and debtors should be permitted to make an application for commencement of insolvency proceedings, without distinguishing between liquidation and reorganization. Recommendation 14 provides:

“14. The insolvency law should specify the persons permitted to make an application for commencement of insolvency proceedings, which should include the debtor and any of its creditors.”²

(a) Debtor application

10. Irrespective of the level of integration of a group, an insolvency law may permit a number of insolvent members of the group to jointly apply for commencement of insolvency proceedings or permit applications already made to be joined, where members satisfy the commencement standard (either on the basis that they are already insolvent or likely to become insolvent, where imminent insolvency is a component of the commencement standard).

¹ UNCITRAL Legislative Guide, part two, chap. I.

² This would include a government authority that is a creditor of the debtor.

11. These possibilities would be within the scope of recommendation 15 of the Legislative Guide, which provides:

“Debtor application

15. The insolvency law should specify that insolvency proceedings could be commenced on the application of a debtor if the debtor can show either that:

- (a) It is or will be generally unable to pay its debts as they mature; or*
- (b) Its liabilities exceed the value of its assets.³”*

12. Recommendation 15 makes no distinction between liquidation and reorganization, referring only to insolvency proceedings. In the context of joint applications, recommendation 15 may be more appropriate to reorganization where it is key to the success of the reorganization that the financial circumstances of closely integrated members of the group be addressed in joint insolvency proceedings and possibly through the preparation of a single reorganization plan (see below). It may also be relevant in liquidation where it would facilitate administration of the proceedings to deal with assets together, such as where the insolvent members are closely integrated, or where certain units of the group can be sold as a going concern.

(b) Applications with respect to a solvent group member

13. Where a group is closely integrated, an insolvency law may also permit an application to include group members that do not satisfy the commencement standard, because it is desirable in the interests of the group as a whole that they be included in those proceedings. Such an application might be made by a parent in respect of subsidiary members of the group or by any member in respect of other members, including the parent. Consideration might also be given to permitting an application by an insolvency representative appointed to the insolvency of the parent, where it is determined to be necessary for the success of the proceedings affecting the parent to include other members of the group. Such an approach may facilitate the preparation of a comprehensive reorganization plan, addressing the assets of both solvent and insolvent members of a group. It could also facilitate development of an insolvency solution for the whole of the group, avoiding piecemeal commencement of proceedings over time, if and when additional members of the group became affected by the insolvency proceedings initiated against the originally insolvent members.

14. Factors relevant to determining whether the necessary degree of integration exists might include: that there is a relationship between the companies that is variously described, but involves, for example, a significant degree of interdependence or control; intermingling of assets; the fictitious nature of the group; unity of identity, reliance on management and financial support or other similar factors that need not necessarily arise from the legal relationship (such as parent-subsidiary) between the companies.

³ The intention of this recommendation and the recommendation on creditor applications is to allow legislators flexibility in developing commencement standards, based on a single or dual test approach. Where the insolvency law adopts a single test, it should be based on the debtor's inability to pay debts as they mature (cessation of payments test) and not on the balance sheet test. Where the insolvency law contains both tests (cessation of payments and balance sheet tests), proceedings can be commenced if one of the tests can be satisfied.

15. A joint application for commencement might also be permitted where all interested members of the group consent to the inclusion of one or more other members, whether they are insolvent or not, or all parties in interest, including creditors, so consented. An insolvency law might also consider whether a group member not involved at the time of commencement of insolvency proceedings against other members of the group might later be joined in those proceedings if it is subsequently affected by those proceedings or determined that its joinder would be in the interests of the group as a whole.

(c) Creditor application

16. Although, as noted above, recommendation 14 of the Legislative Guide recommends that both creditors and debtors should be permitted to apply for commencement of insolvency proceedings, without distinguishing between liquidation and reorganization, it also notes that a number of laws only permit debtor applications for reorganization. While there may be no reason to justify departure, in the case of a corporate group, from the general approach that recommends creditors be permitted to apply for commencement of both liquidation and reorganization, the structure of a corporate group may raise particular difficulties for creditors.⁴ In some cases, especially where the group is loosely organized, the particular debtor may be easily identified. Where there is a high degree of integration, however, the issue may be less clear, especially where the creditor believed that it was dealing with the group as a single enterprise, and it may be particularly difficult for a creditor to identify the specific part of the group or a particular debtor with which it dealt and provide the evidence necessary to satisfy the commencement standard. For the same reasons, it might be difficult for a creditor to determine whether liquidation or reorganization proceedings would be more appropriate for a particular debtor where the insolvency law requires such a determination to be made at the time of the application.

17. If certain members of the group are not included in a debtor application under recommendation 15, they might subsequently be the subject of an application by creditors under recommendation 16, which could include a group member that was a creditor of an insolvent group member. Recommendation 16 provides:

“Creditor application

16. The insolvency law should specify that insolvency proceedings could be commenced on the application of a creditor if it can be shown that either:

- (a) The debtor is generally unable to pay its debts as they mature; or*
- (b) The debtor’s liabilities exceed the value of its assets.”*

(d) Application by a government or regulatory authority

18. The Legislative Guide discusses the issue of governmental or other supervisory authorities having the authority to apply for commencement of insolvency proceedings and concludes that such a power should only be available in very limited circumstances and only as a last resort in the absence of appropriate remedies under other laws (see part two, chap. I, paras. 42-44). The Legislative

⁴ UNCITRAL Legislative Guide, part two, chap. I, paras. 37-41 and 48-53, for a discussion of creditor applications.

Guide outlines those circumstances and the desirability of limiting the use of such a power to applications for liquidation.

19. The same considerations would apply to applications by government or regulatory authorities for commencement of insolvency proceedings against two or more members of a corporate group.

3. Notice of application and commencement

(a) Debtor application: notice to creditors

20. Since the rights of creditors of each of the group members involved in a joint administration should not be altered without their agreement, it is desirable that an insolvency law include provisions requiring notice of the commencement of joint proceedings (where the application is made by one or more members of the corporate group) to be given to the creditors of all members involved in the insolvency proceedings. It may be desirable to require notice to be provided to the creditors of all members of the group, particularly where the group is closely integrated and the solvency of members not included in the proceedings may be influenced by the proceedings. Recommendations 24 and 25 of the Legislative Guide address the provision of notice on commencement of insolvency proceedings on an application by the debtor and should apply equally in the context of a corporate group. Creditors disputing issues of insolvency or objecting to joint administration could do so after commencement of the proceedings.

21. Additional information concerning the effect of joint administration could be added to the information to be provided under recommendation 25 of the Legislative Guide, particularly as it affects creditors. That information would be of particular importance to creditors of any solvent member of a group that was included in insolvency proceedings.

(b) Creditor application: notice to the debtor

22. Similarly, recommendation 19 of the Legislative Guide, concerning commencement on a creditor application, should apply in the group context, requiring notice of the application for commencement to be given to those members of the corporate group included in the application, providing them with an opportunity to object. Consideration may also be given to whether notice should be given to members of the corporate group not included in the application, but which may nevertheless be affected by the insolvency proceedings.

Recommendations

Commencement of insolvency proceedings: corporate groups

(1) The insolvency law may permit a joint application for commencement of [insolvency] [reorganization] proceedings to be made by two or more members of a corporate group that satisfy the commencement standard in recommendation 15 of the Legislative Guide.

(2) The insolvency law may permit a joint application for commencement of [insolvency] [reorganization] proceedings to be made by two or more members of a corporate group provided one of them satisfies the commencement standard in recommendation 15 of the Legislative Guide.

(3) The insolvency law may permit an application for commencement of [insolvency] [reorganization] proceedings by [one or more members] [the parent] of a corporate group that satisf[y][ies] the commencement standard of recommendation 15 to be extended to include one or more [members] [subsidiaries] of the group that do not satisfy that standard, where:

(a) [The members to which the application is to be extended] [all members of the group] [creditors of the group member to be included] [all interested parties] consent; or

(b) The court determines that the members of the group to be included in the application are controlled by the insolvent parent; the assets of those members of the group cannot be separated; the affairs of the solvent group member are so intermingled with those of other group members that it would be beneficial for the solvent group member to be included in reorganization proceedings; or creditors have dealt with the group as a single unit.

(4) The insolvency law may permit a parent of a group of companies that meets the commencement standard of recommendation 15 of the Legislative Guide, to determine the other members of the group that should be included in a joint application for commencement of [insolvency] [reorganization] proceedings under recommendation (1).

Debtor application: notice to creditors

(5) The insolvency law should specify that, when joint insolvency proceedings commence against two or more members of a corporate group, notice of the commencement is to be given to all creditors of [members of the corporate group against which proceedings have commenced] [all members of the corporate group, including solvent members].

(6) The insolvency law should specify that the notice of insolvency proceedings is to include, in addition to the information specified in recommendation 25, information on the conduct of the joint administration of particular relevance to creditors.

Creditor application: notice to the debtor

(7) The insolvency law should specify that when an application is made by a creditor for commencement of insolvency proceedings against two or more members of a corporate group, notice of the application is to be given to all [members of the corporate group included in the application] [all members of the corporate group].

Joint administration

(8) The insolvency law may permit two or more [insolvency] [reorganization] proceedings pending [in the same court] against members of the same corporate group to be jointly administered.

Notes on recommendations

23. Recommendations (1)-(4) address the issue of joint applications for commencement of insolvency proceedings against two or more members of a corporate group.

24. Recommendation (1) is intended to address a joint application by all members of a corporate group that satisfy the commencement standard of recommendation 15 of the Legislative Guide.

25. Recommendation (2) is intended to address a joint application by a number of members of a corporate group, provided one of them satisfies the commencement standard of recommendation 15. This would allow solvent members to be included in the application for commencement, without specifying any conditions for that inclusion.

26. Recommendation (3) adopts a different approach, permitting an application made by certain members of a group to be extended to include other members, provided certain conditions are satisfied. The chapeau is drafted to reflect two alternatives: the first is an application by any member that satisfies the commencement standard of recommendation 15 that may be extended to any member that does not satisfy recommendation 15; the second is an application by a parent company satisfying the commencement standard that may be extended to include a subsidiary that does not satisfy that standard. The conditions include, in subparagraph (a), alternatives for extension by consent of relevant parties, including the group member to be included; all members of the group; creditors of the group member to be included; and all interested parties, which would include creditors (whether of the group member to be included or of all group members) and members of the group. Subparagraph (b) establishes conditions based upon control and integration.

27. Recommendation (4) permits the insolvent parent of a corporate group to determine which other members of the group should be included in an application for commencement of insolvency proceedings under recommendation (1).

28. Each of recommendations (1)-(4) includes an alternative with respect to the proceedings to be commenced: insolvency generally, as included in recommendation 15 of the Legislative Guide, or only reorganization, on the basis that these recommendations may be more appropriate to the reorganization of a corporate group.

29. Recommendations (5)-(7) address the provision of notice on application for commencement of proceedings in the case of a creditor application and on commencement in the case of a debtor application, closely following recommendations 19 and 22 of the Legislative Guide; those recommendations establish the difference in the time at which notice is to be given, depending upon whether the application for commencement is made by the debtor or a creditor.

30. Recommendation (8) addresses the possibility that, where insolvency proceedings have already commenced against two or more members of a group, they could be jointly administered.

B. Treatment of assets on commencement of insolvency proceedings

[Reference: Legislative Guide: part two, chap. II, paras. 1-215, and recommendations 35-107; chap. III, paras. 35-74 and recommendations 115-125]

31. The ways in which the commencement of insolvency proceedings affect the debtor and its assets are discussed in detail in the Legislative Guide.⁵ In general, those effects would apply equally to commencement of insolvency proceedings against two or more members of a corporate group. Some of the effects that might differ in the group context are discussed below, with respect to administration of the estates of group members; appointment of an insolvency representative; application of the stay; use and disposal of assets; post-commencement finance; avoidance; subordination; and remedies, including contribution and consolidation orders.

1. Joint administration and appointment of an insolvency representative

32. A joint application would give rise to joint administration (sometimes also referred to as procedural or administrative consolidation) of the estates of those group members included in the proceedings, but should not affect the substantive rights of each of those debtors or the liability of each member to its own creditors. To save time and costs, certain procedures may be able to be conducted jointly, for example meetings of creditors of two or more members of the group being administered. Consideration could be given to whether or not the consent of all affected creditors would be required. Voting would remain separate for each group member on issues relevant to that member.

33. Joint administration of the different estates would be facilitated by the appointment of a single insolvency representative. Such an appointment would ensure coordination of the administration of the various group members, reduce related costs and facilitate the gathering of information on the corporate group as a whole.

34. While many insolvency laws do not address this question, there are some jurisdictions where appointment of a single insolvency representative in the group context has become a practice. This has also been achieved to a limited extent in some cross-border insolvency cases (discussed further below).

35. Where a single insolvency representative is appointed to administer a group involving multiple debtors with complex financial and business relationships and different groups of creditors, conflict may arise, for example, with respect to cross-guarantees, intra-group debts or the wrongdoing by one group member with respect to another group member. As a safeguard against possible conflict, the insolvency representative could be required to give an undertaking or be subject to a practice rule or statutory obligation to seek direction from the court in the event a conflict arises. Additionally, the insolvency law could provide for the appointment of a further insolvency representative to administer the other debtor or debtors involved in the conflict. The obligation of disclosure contained in recommendations 116 and 117 of the Legislative Guide may be relevant to conflict situations arising in a group context.

36. If appointment of a single insolvency representative is not possible, or if more than one insolvency representative is required to be appointed because of an apparent conflict, an insolvency law could specify obligations additional to those applicable to insolvency representatives under the Legislative Guide (recommendations 111, 116-117, 120) to facilitate coordination of the different proceedings. These obligations might include: sharing and disclosure of information; cooperation on use and disposal of assets; proposal and negotiation of

⁵ UNCITRAL Legislative Guide, part two, chap. II.

coordinated reorganization plans (unless preparation of a single group plan is possible as discussed below); coordination of use of avoidance powers; obtaining of post-commencement finance; and coordination of filing and admission of claims.

37. The insolvency law could also address timely resolution of disputes between the different insolvency representatives appointed. Consideration might be given to the question of whether, in a group context, where different insolvency representatives are appointed to administer the parent and different subsidiaries, the insolvency representative appointed to the parent should have any additional coordinating role with respect to the other insolvency representatives or additional powers to resolve disputes or conflicts.

Recommendations

Appointment of a single insolvency representative

(9) The insolvency law should specify that, where insolvency proceedings against two or more members of a corporate group are to be jointly administered, a single insolvency representative may be appointed to conduct that joint administration.

(10) The insolvency law should include measures to address a conflict of interest that might arise in a joint administration where only one insolvency representative is initially appointed. Such measures could include the appointment of an additional insolvency representative.

Appointment of more than one insolvency representative

(11) The insolvency law should specify that, where insolvency proceedings are commenced against two or more members of a corporate group and more than one insolvency representative is appointed, the insolvency representatives should cooperate to the maximum extent possible to facilitate coordination of the administration of the proceedings.

Notes on recommendations

38. Recommendation (9) permits a single insolvency representative to be appointed to a joint administration of insolvency proceedings against two or more members of a corporate group.

39. Recommendation (10), in addition to recommendations 116 and 117 of the Legislative Guide, addresses the issue of conflict that may arise in a joint administration and proposes one way in which that conflict might be addressed. Other possible means that could be included in the recommendation are referred to in the commentary, paragraph 35 above.

40. Recommendation (11) addresses the key importance of facilitating coordination of the proceedings where more than one insolvency representative is appointed in a joint administration. It uses the wording of articles 25 and 26 of the UNCITRAL Model Law on Cross-Border Insolvency: “cooperate to the maximum extent possible”. What that cooperation might cover or how it might be achieved, as discussed in paragraph 36 of the commentary, could be included in the recommendation by way of example.

2. Application of the stay

41. The Legislative Guide notes⁶ that many insolvency laws include a mechanism to protect the value of the insolvency estate that not only prevents creditors from commencing actions to enforce their rights through legal remedies during some or all of the period of insolvency proceedings, but also suspends actions already under way against the debtor. The provisions of the Legislative Guide relating to the application of that mechanism, referred to as a “stay”, would apply generally in the case of insolvency proceedings against two or more members of a corporate group (see recommendations 39-51).

42. One issue that might arise in the context of the insolvency of corporate groups is the extension of the stay to a solvent member that is not subject to the insolvency proceedings (where the insolvency law permits a solvent member of a group to be included in the proceedings, as discussed above, this issue will not arise). Such an extension might be necessary, for example, to protect an intra-group guarantee that relies upon the assets of the solvent group member providing the guarantee. Such extension of the stay has the potential to affect the business of the solvent member and the interests of its creditors, depending upon the nature of the solvent member and its function within the group structure. The day-to-day activities of a trading group member, for example, may be more adversely affected than those of a subsidiary established to hold certain assets or obligations.

43. In some jurisdictions, ordering insolvency-related relief against a solvent member of a group (not included in insolvency proceedings) might not be possible as it might conflict, for example, with the protection of property rights or raises issues of constitutional rights. Nevertheless, it might be possible to achieve the same effect if a court could order provisional measures in conjunction with the commencement of insolvency proceedings against other members of that corporate group in certain cases, such as where there is an intra-group guarantee. The measures may be available at the courts’ discretion, subject to such conditions as the court determines appropriate.

44. Such measures might be covered by recommendation 48 of the Legislative Guide, which provides for the court to grant relief in addition to any relief that might be applicable automatically on commencement of insolvency proceedings (such as that addressed in recommendation 46). As the footnote to recommendation 48 points out, that additional relief would depend upon the types of measures available in a particular jurisdiction and the measures that might be appropriate in a particular insolvency proceeding.

45. Protection for the interests of the creditors, both secured and unsecured, of the solvent member of the group, might be found in the relevant provisions of the Legislative Guide; recommendation 51 for example specifically addresses the issue of protection of secured creditors and grounds for relief from the stay applicable on commencement and might be extended to secured creditors of the solvent group member. Other grounds for relief from the stay might relate to the financial situation of the solvent member and the continuing effect of the stay on its day-to-day operations and, potentially, its solvency.

46. Where a secured creditor is another member of the same corporate group, a different approach to the question of protection might be required, especially where

⁶ UNCITRAL Legislative Guide, part two, chap. II, para. 26.

the insolvency law permits consolidation or subordination of related person claims (see below).

Recommendations

(12) The law should specify that, where insolvency proceedings have commenced against two or more members of a corporate group, the court may grant relief at the request of [a member of the corporate group] [the insolvency representative] where relief is needed to protect and preserve the value of the assets of a member of the corporate group not subject to the insolvency proceedings.

That relief may include:

(a) Staying the commencement or continuation of individual actions or proceedings concerning the assets, rights, obligations or liabilities of the member of the corporate group not subject to the insolvency proceedings;

(b) Staying execution or other enforcement against the assets of the member of the corporate group not subject to the insolvency proceedings;

(c) Suspending the right of a counterparty to terminate any contract with the member of the corporate group not subject to the insolvency proceedings; and

(d) Suspending the right to transfer, encumber or otherwise dispose of any assets of the member of the corporate group not subject to the insolvency proceedings.

Notes on recommendations

47. At its thirty-first session the Working Group agreed that the effects of a stay should not be automatically extended to solvent members of a group, but that there would be certain cases where it could be extended at the discretion of the court and subject to certain conditions.⁷

48. Recommendation (12) is an outline of the types of measure that might apply in such circumstances, based upon recommendation 39 of the Legislative Guide. The Working Group may wish to consider the specific circumstances in which such relief might be appropriate and any conditions to which it might be subject.

49. The Working Group also noted⁸ that recommendation 51 of the Legislative Guide, which addresses relief from measures applicable on commencement of insolvency proceedings, may have some application beyond secured creditors where the stay is ordered against a member of the group not subject to the insolvency proceedings. The Working Group may wish to consider, against the background of recommendation 51, grounds for relief from the stay referred to in recommendation (12) and their application to both secured and unsecured creditors.

3. Use and disposal of assets

50. The Legislative Guide notes⁹ that, although as a general principle it is desirable that an insolvency law not interfere unduly with the ownership rights of

⁷ Report of Working Group V (Insolvency Law) on the work of its thirty-first session, A/CN.9/618, para. 31.

⁸ Ibid., para. 30.

⁹ UNCITRAL Legislative Guide, part two, chap. II, para. 74.

third parties or the interests of secured creditors, the conduct of insolvency proceedings will often require assets of the insolvency estate, and assets in the possession of the debtor being used in the debtor's business, to continue to be used or disposed of (including by way of encumbrance) in order to enable the goal of the particular proceedings to be realized.

51. Where insolvency proceedings concern two or more members of a corporate group, issues may arise with regard to the use of assets belonging to a solvent member of the same group to support ongoing operations of the insolvent members pending resolution of the proceedings. Where those assets are in the possession of one of the insolvent group members, recommendation 54 of the Legislative Guide, which addresses the use of third party owned assets in the possession of the debtor, may be sufficient. Recommendation 54 provides:

“Use of third-party-owned assets

54. The insolvency law should specify that the insolvency representative may use an asset owned by a third party and in the possession of the debtor provided specified conditions are satisfied, including:

(a) The interests of the third party will be protected against diminution in the value of the asset; and

(b) The costs under the contract of continued performance of the contract and use of the asset will be paid as an administrative expense.”

52. Where those assets are not in the possession of any of the insolvent group members, recommendation 54 generally will not apply. There may be circumstances, however, where the solvent group member is included in the insolvency proceedings and the provisions of a group reorganization plan would cover the assets. Where the solvent group member is not included in the proceedings, the question will be whether those assets can be used to support the insolvent group members and if so, the conditions to which that use would be subject. The use of those assets might raise questions of avoidance, particularly where the supporting member subsequently became insolvent, and also raises concerns for creditors of the solvent member.

53. The Working Group may wish to consider the circumstances in which assets of a solvent group member could be used to support the reorganization of insolvent members of the same group, where that solvent member is not subject to the insolvency proceedings.

4. Post-commencement finance

54. The Legislative Guide¹⁰ recognizes that the continued operation of the debtor's business after the commencement of insolvency proceedings is critical to reorganization and, to a lesser extent, liquidation where the business is to be sold as a going concern. To maintain its business activities, the debtor must have access to funds to enable it to continue to pay for crucial supplies of goods and services, including labour costs, insurance, rent, maintenance of contracts and other operating expenses, as well as costs associated with maintaining the value of assets. The Guide notes, however, that many jurisdictions restrict the provision of new money in insolvency or do not specifically address the issue of new finance or the priority

¹⁰ UNCITRAL Legislative Guide, part two, chap. II, section D, para. 94, Purpose of legislative provisions preceding recommendation 63.

for its repayment in insolvency. Very few, if any, of those laws specifically address the issue in the context of corporate groups.

55. The Legislative Guide includes recommendations 63-68, which aim to promote the availability of finance for continued operation or survival of the debtor's business and provide appropriate protection for the providers of post-commencement finance, as well as appropriate protection for those parties whose rights may be affected by the provision of post-commencement finance.

56. While post-commencement finance is important in the context of individual proceedings, as noted in the Legislative Guide, it is even more critical in the group context; if there are no ongoing funds there is very little prospect of reorganizing an insolvent group. One of the questions with respect to post-commencement finance in the corporate group context is whether the assets of a solvent member of a group can be used to obtain financing for an insolvent member from an external source or to fund the insolvent member directly and, if so, what are the implications for the recommendations of the Legislative Guide concerning priority and security. For example, would a solvent subsidiary be entitled to priority under recommendation 64 if it provided funding to its insolvent parent or would that transaction be subject to subordination as intra-group lending? Using group assets to obtain financing may generally be possible where all members of the group are subject to insolvency proceedings; this would be covered by the recommendations of the Legislative Guide. Difficulties are likely to arise, however, where it is proposed that the assets of a solvent member be used to fund an insolvent member or as the basis for obtaining external funding. In general, as noted above, it is not likely to be permitted by insolvency law, although there might be situations where funding could be provided if the creditors of the solvent member consented.

57. In addition to the recommendations included below, recommendation 68 of the Legislative Guide will be relevant where reorganization proceedings are converted to liquidation.

Recommendations

Attracting and authorizing post-commencement finance for a corporate group

(13) The insolvency law should specify that a corporate group or any member of a corporate group can obtain post-commencement financing under the circumstances and standards set forth in recommendations 15-18, below.

(14) The insolvency law should facilitate and provide incentives for post-commencement finance to be obtained by [the insolvency representative of a corporate group] [an insolvency representative of any member of a corporate group] where the insolvency representative determines it to be necessary for the continued operation or survival of the business of the [corporate group [or any of its members]], or the preservation or enhancement of the value of the estates of one or more members of the group. The insolvency law may require the court to authorize, or the creditors of any affected member of the group to consent to the provision of post-commencement finance for the group [or any member of the group], as specified in recommendation 18 and 19, below.

Guarantee or other assurances for repayment of post-commencement finance for a corporate group

(15) The insolvency law should specify that a member of a [corporate group [that is a debtor]] may guarantee or provide other assurance of repayment for post-commencement finance obtained by another member of the corporate group so long as the court determines that:

(a) [The estate of] the debtor-guarantor would receive benefits from such post-commencement finance comparable to those received by the obtainer of post-commencement finance; or

(b) The [creditors] [insolvency representative] of the debtor-guarantor consent to the provision of that guarantee or other assurance of repayment; or

(c) The creditors of the debtor-guarantor would suffer no economic harm as a result of such guarantee or other assurance of repayment.

Priority for post-commencement finance for a corporate group

(16) The insolvency law should establish the priority that may be accorded to post-commencement finance provided to [a corporate group] [or member of a corporate group], ensuring at least the payment of the post-commencement finance provider ahead of the ordinary unsecured creditors of each member of the group, including those unsecured creditors with administrative priority.

Security for post-commencement finance for a corporate group

(17) The insolvency law should enable a member of a corporate group to grant a security interest for repayment of post-commencement finance provided to the group [or member of the group], including a security interest on an unencumbered asset, including an after-acquired asset, or a junior or lower priority security interest on an already encumbered asset of the estate of such member of the group.

(18) The law¹¹ should specify that a security interest over the assets of the estate of any member of the corporate group granted to secure post-commencement finance for [any other member of] the group does not have priority ahead of any existing security interest over the same assets unless the insolvency representative [of each affected member of the group] obtains the agreement of existing secured creditor(s) or follows the procedure in recommendation 19.

(19) The insolvency law should specify that, where any existing secured creditor does not agree [that post-commencement finance should be accorded a priority senior to its security interest], the court may authorize the creation of a security interest having priority over pre-existing security interests provided specified conditions are satisfied, including:

(a) The existing secured creditor was given the opportunity to be heard by the court;

(b) It can be proven that the corporate group cannot obtain the finance [in any other way] [on more favourable terms and conditions]; and

(c) The interests of the existing secured creditor will be protected.

¹¹ This rule may be in a law other than the insolvency law, in which case the insolvency law should note the existence of the provision.

Notes on recommendations

58. With the exception of recommendation (15), these recommendations are based upon recommendations 63-67 of the Legislative Guide.

59. To some extent, recommendations (13) and (14) overlap. Recommendation (13) specifically requires the insolvency law to include provisions enabling post-commencement finance and specifying the applicable circumstances and conditions. Recommendation (14) is based on recommendation 63 of the Legislative Guide and is of general application, focussing upon the desirability of providing incentives for post-commencement finance and addressing the question of consent; it does not explicitly refer to the need for statutory provisions on post-commencement finance.

60. Recommendation (15) addresses the situation where post-commencement finance may be obtained by one member of a group for use by another member and permits the first member to guarantee its repayment, provided certain conditions are met. By including the phrase “[that is a debtor]”, it leaves open the question of whether the member of the group providing the guarantee could be a group member not subject to the insolvency proceedings.

61. As drafted, these recommendations leave open issues of (i) the consolidated administration of the estates of the members of a corporate group; (ii) appointment of one insolvency representative for the corporate group as a whole; and (iii) inclusion of a solvent member of a corporate group in insolvency proceedings related to the other, insolvent, members of the group.

[*The continuation of* III. The onset of insolvency: domestic issues *is contained in* A/CN.9/WP.76/Add.1; IV. International issues *is contained in* A/CN.9/WP.76/Add.2.]

A/CN.9/WG.V/WP.76/Add.1 [Original: English]**Note by the Secretariat on the treatment of corporate groups in insolvency,
submitted to the Working Group on Insolvency Law at its thirty-second session****ADDENDUM****CONTENTS**

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III. The onset of insolvency: domestic issues**B. Treatment of assets on commencement of insolvency proceedings
(*continued*)****5. Avoidance**

[Reference: Legislative Guide: part two, chap. II, paras. 148-203 and recommendations 87-99]

1. The recommendations of the UNCITRAL Legislative Guide on Insolvency Law¹ relating to avoidance would generally apply to avoidance of transactions in the context of a corporate group, although additional considerations may apply to transactions between members of the group. A significant expenditure of time and money may be required to disentangle the layers of intra-group transactions in order to determine which, if any, are subject to avoidance. Some transactions that might appear to be preferential or undervalued as between the immediate parties might be considered differently when viewed in the broader context of a closely integrated group, where the benefits and detriments of transactions might be more widely assigned. Similarly, some transactions occurring within a group that might be for legitimate purposes would not take place outside the group if the benefits and detriments were analysed on normal commercial grounds.

2. Intra-group transactions may represent trading between group members; channelling of profits upwards from the subsidiary to the parent; loans from one member to another to support continued trading by the borrowing member; asset transfers and guarantees between group members; payments by a company to a creditor of a related company; a guarantee or mortgage given by one group company to support a loan by an outside party to another group company; or a range of other transactions. A group may have the practice of putting all available money and assets in the group to the best commercial use in the interests of the group as a whole, as opposed to the benefit of the group member to which they belong. This might include sweeping cash from subsidiaries into the financing member of the group. Although this might not always be in the best interests of the subsidiary, some laws permit directors of wholly owned subsidiaries, for example, to act in that manner, provided it is in the best interests of the parent.

3. Some of the transactions occurring in the group context may be clearly identified as falling within the categories of transactions subject to avoidance under recommendation 87² of the Legislative Guide. Other transactions may not be so clearly within the scope of recommendation 87 and may raise issues concerning the extent to which the group was operated as a single enterprise or the assets and liabilities of group members were closely intermingled, thus potentially affecting the nature of the transactions between members and between members and external creditors. There may also be transactions that are not covered by the terms of avoidance provisions. Some insolvency laws, for example, may provide for

¹ UNCITRAL Legislative Guide, recommendations 87-99.

² Recommendation 87 provides:

Avoidable transactions

87. The insolvency law should include provisions that apply retroactively and are designed to overturn transactions, involving the debtor or assets of the estate, and that have the effect of either reducing the value of the estate or upsetting the principle of equitable treatment of creditors. The insolvency law should specify the following types of transaction as avoidable:

(a) Transactions intended to defeat, delay or hinder the ability of creditors to collect claims where the effect of the transaction was to put assets beyond the reach of creditors or potential creditors or to otherwise prejudice the interests of creditors;

(b) Transactions where a transfer of an interest in property or the undertaking of an obligation by the debtor was a gift or was made in exchange for a nominal or less than equivalent value or for inadequate value that occurred at a time when the debtor was insolvent or as a result of which the debtor became insolvent (undervalued transactions); and

(c) Transactions involving creditors where a creditor obtained, or received the benefit of, more than its pro rata share of the debtor's assets that occurred at a time when the debtor was insolvent (preferential transactions).

avoidance of preferential payments to a debtor's own creditors, but not to the creditors of a related group member, unless the payment is made, for example, pursuant to a guarantee.

4. Transactions between members of a corporate group might be covered by those provisions of an insolvency law dealing with transactions between related persons. The Legislative Guide defines "related person" to include members of a corporate group such as a parent, subsidiary, partner or affiliate of the insolvent member of the group against which insolvency proceedings have commenced or a person, including a legal person, that is or has been in control of the debtor. Those transactions are often subject, under the insolvency law, to stricter avoidance rules than other transactions, in particular with regard to the length of suspect periods, as well as presumptions or shifted burdens of proof to facilitate avoidance proceedings³ and dispensing with requirements that the debtor was insolvent at the time of the transaction or was rendered insolvent as a result of the transaction. A stricter regime may be justified on the basis that these parties are more likely to be favoured and tend to have the earliest knowledge of when the debtor is, in fact, in financial difficulty.

5. One approach to the burden of proof in the case of transactions with related persons might be to provide that the requisite intent or bad faith is deemed or presumed to exist where certain types of transaction are undertaken within the suspect period and the counterparty to the transaction will have the burden of proving otherwise. In the context of corporate groups, some laws have established a rebuttable presumption that transactions among corporate group members and between those members and the shareholders of that corporate group would be detrimental to creditors and therefore subject to avoidance. Additionally, the claims of the related group member may be subjected to special treatment and the rights of related group members under intra-group debt arrangements deferred or subordinated to the rights of external creditors of the insolvent members (on subordination, see below).

6. With respect to the commencement of avoidance actions, the level of integration of the group may also have the potential to significantly affect the ability of creditors to identify the group member with which they dealt where the insolvency law permits them to commence avoidance proceedings.

Recommendations

Avoidance

(20) The insolvency law should specify that, in considering whether a transaction of the kind referred to in recommendation 87 (a), (b) or (c) of the Legislative Guide that took place between related persons in a corporate group context should be avoided, the court may have regard to the circumstances of the group in which the transaction took place. Those circumstances may include: the degree of integration between the members of the corporate group that are party to the transaction; the

³ See Legislative Guide, recommendation 97, which provides:

97. The insolvency law should specify the elements to be proved in order to avoid a particular transaction, the party responsible for proving those elements and specific defences to avoidance. Those defences may include that the transaction was entered into in the ordinary course of business prior to commencement of insolvency proceedings. The law may also establish presumptions and permit shifts in the burden of proof to facilitate the conduct of avoidance proceedings.

purpose of the transaction; and whether the transaction granted advantages to members of the group that would not normally be granted between unrelated parties.

(21) The insolvency law may specify that, with respect to the elements referred to in recommendation 97 of the Legislative Guide and their application in the context of a corporate group, special provisions concerning defences and presumptions apply.

Notes on recommendations

7. Recommendation (20) takes note of the fact that transactions occurring within a corporate group raise considerations additional to those generally applying to transactions between related parties. While the provisions of the Legislative Guide would generally apply, the Working Group may wish to consider whether those additional considerations should be reflected in recommendations.

8. At its thirty-first session, the Working Group noted that broad application of rebuttable presumptions concerning transactions between corporate group members and between those members and the shareholders of that group could be detrimental to creditors and should be avoided.⁴ Recommendation (21) notes the need for special consideration to be given to the application of burden of proof provisions and the use of presumptions in the corporate group context, without specifying the detail.

6. Subordination

[Reference: Legislative Guide: part two, chap. V, paras. 55-61]

9. The Legislative Guide notes⁵ that subordination refers to a rearranging of creditor priorities in insolvency and does not relate to the validity or legality of the claim. Notwithstanding the validity of a claim, it might nevertheless be subordinated because of a voluntary agreement or a court order. Two types of claims that typically may be subordinated in insolvency are those of persons related to the debtor and of owners and equity holders of the debtor.

(a) Related person claims

10. In the corporate group context, subordination of related person claims might mean, for example, that the rights of group members under intra-group arrangements could be deferred to the rights of external creditors of those group members subject to insolvency proceedings.

11. As noted above, the term “related person” as used in the Legislative Guide would include members of a corporate group. The mere fact of a special relationship with the debtor, including, in the corporate group context, being another member of the same group, may not be sufficient in all cases to justify special treatment of a creditor’s claim. In some cases these claims will be entirely transparent and should be treated in the same manner as similar claims made by creditors who are not related persons; in other cases they may give rise to suspicion and will deserve special attention. An insolvency law may need to include a mechanism to identify those types of conduct or situation in which claims will deserve additional attention.

⁴ Report of Working Group V (Insolvency Law) on the work of its thirty-first session, A/CN.9/618, para. 44.

⁵ UNCITRAL Legislative Guide, part two, chap. V, para. 56.

Similar considerations apply, as noted above, with respect to avoidance of transaction occurring between members of a corporate group.

12. The Legislative Guide identifies a number of situations in which special treatment of a related person's claim might be justified (e.g. where the debtor is severely undercapitalized and where there is evidence of self-dealing). In the group context, additional considerations might include, as between a parent and a controlled subsidiary, the parent's participation in the management of the subsidiary; whether the parent has sought to manipulate intra-group transactions to its own advantage at the expense of external creditors; or whether the parent has otherwise behaved unfairly, to the detriment of creditors and shareholders of the controlled group member. Under some laws, the existence of those circumstances might result in the parent having its claims subordinated to those of unrelated unsecured creditors or even minority shareholders of the controlled company.

13. Some laws include other approaches to intra-group transactions such as permitting debts owed by a group member that borrowed funds under an intra-group lending arrangement to be involuntarily subordinated to the rights of external creditors of that borrowing member, permitting the court to review intra-group financial arrangements to determine whether particular funds given to a group member should be treated as an equity contribution rather than as a loan, where equity contributions are subordinated to creditor claims (on treatment of equity, see below); and allowing voluntary subordination of intra-group claims to those of external creditors.

14. The practical result of a subordination order in a corporate group context might be to reduce or effectively extinguish any repayment to those group members whose claims have been subordinated if the claims of secured and unsecured external creditors are large in relation to the funds available for distribution. In some cases this might threaten the viability of the subordinated group member and be detrimental not only to its own creditors, but also its shareholders.

(b) Treatment of equity

15. The Legislative Guide notes⁶ that many insolvency laws distinguish between the claims of owners and equity holders that may arise from loans extended to the debtor or their ownership interest in the debtor. With respect to claims arising from equity interests, many insolvency laws adopt the general rule that the owners and equity holders of the business are not entitled to a distribution of the proceeds of assets until all other claims that are senior in priority have been fully repaid (including claims of interest accruing after commencement). As such, these parties will rarely receive any distribution in respect of their interest in the debtor. Where a distribution is made, it would generally be made in accordance with the ranking of shares specified in the company law and the corporate charter. Debt claims, such as those relating to loans, however, are not always subordinated.

16. Few insolvency laws specifically address subordination of equity claims in the corporate group context. One that does allows the courts to review intra-group financial arrangements to determine whether particular funds given to a group member that is now subject to insolvency proceedings should be treated as an equity contribution, rather than as an intra-group loan, enabling it to be postponed behind creditors' claims. Those funds are likely to be treated as equity where the original

⁶ UNCITRAL Legislative Guide, part two, chap. V, para. 76.

debt to equity ratio was high before the funds were contributed and the funds would reduce the ratio; if the paid-up share capital was inadequate; if it is unlikely that an external creditor would have made a loan in the same circumstances; and if the terms on which the advance was made were not reasonable and there was no reasonable expectation of repayment.

17. The Working Group may wish to consider the need for recommendations dealing with subordination in the context of a corporate group and the circumstances in which subordination might be appropriate.

C. Remedies

1. Introduction

18. Because of the nature of corporate groups and the way in which they operate, there may be, as noted above, a complex web of financial transactions between members of the group, and creditors may have dealt with different members or even with the group as a single economic entity, rather than with individual members. Disentangling the ownership of assets and liabilities and identifying the creditors of each member of the group may involve a complex and costly legal inquiry. However, because adherence to the separate entity approach means that creditors of each group member must in general look to that group member for payment of their debt, it will generally become necessary, where insolvency proceedings have commenced against one or more of the members of that group, to disentangle the ownership of their assets and liabilities.

19. Where this disentangling can be effected, adherence to the separate entity principle operates to limit creditor recovery to the assets of the insolvent group member. Where it cannot be effected or other specified reasons exist to treat the group as a single enterprise, some laws include remedies that allow the single entity approach to be set aside. Historically, these remedies have been developed to overcome the perceived inefficiency and unfairness of the traditional separate entity approach in specific cases. In addition to setting aside intra-group transactions or subordinating intra-group lending, the remedies include: extending liability for external debts to other solvent members of the group, as well as to office holders and shareholders; contribution orders; and pooling or (substantive) consolidation orders. Some of these remedies require findings of fault to be made, while others rely upon the establishment of certain facts with respect to the operations of the corporate group. In some cases, particularly where misfeasance of management is involved, other remedies might be more appropriate, such as removal of the offending directors and limiting management participation in reorganization.

20. Because of the potential inequity that may result when one creditor group is forced to share assets and liabilities with other creditors of another group member that may be less solvent, these remedies are not universally available, generally not comprehensive and apply only in restricted circumstances. Those remedies involving extension of liability may involve “piercing” or “lifting the corporate veil”, by which shareholders, who are generally shielded from liability for the corporation’s activities, can be held liable for certain activities. The other remedies discussed here do not, although in some circumstances the effect may appear to be similar.

2. Contribution orders

21. A contribution order is an order by which a court can require a solvent member of a corporate group to contribute specific funds to cover all or some of the debts of other group members in liquidation. Although contribution orders are not widely available under insolvency laws, a few jurisdictions have adopted or are considering adopting these measures. Under those laws that do permit contribution orders, the problem, as noted above, of reconciling the interests of the two sets of unsecured creditors that have dealt with the two separate group companies, has meant that the power to make a contribution order is not commonly exercised. Courts have also taken the view that a full contribution order may be inappropriate if the effect is to threaten the solvency of the related company not already in liquidation, although it might be possible to order a partial contribution that is limited to certain assets, such as the balance remaining after meeting bona fide obligations.

22. Under one law that does provide for contribution orders, the court must take into account certain specified circumstances in considering whether to make an order. These include: the extent to which a related company took part in the management of the company in liquidation; the conduct of the related company towards the creditors of the company in liquidation, although creditor reliance on the existence of a relationship between the companies is not sufficient grounds for making an order; the extent to which the circumstances giving rise to liquidation are attributable to the actions of the related company; the conduct of the solvent company after commencement of the liquidation of its related company, particularly if it indirectly or directly affects the creditors of the related company, such as with respect to failure to perform a contract; and such other matters as the court thinks fit.⁷

3. Substantive consolidation or pooling

(a) Introduction

23. Another remedy is substantive consolidation or pooling (referred to as consolidation). As noted above, where joint administration occurs, the assets and liabilities of the debtors remain separate and distinct, with the substantive rights of claimants unaffected. Consolidation, however, permits the court, in insolvency proceedings involving two or more members of the same corporate group, to disregard the separate identity of each group member in appropriate circumstances and consolidate their assets and liabilities, treating them as though held and incurred by a single entity. This has the effect of creating a single estate for the general benefit of all creditors of all consolidated group members. Consolidation would generally involve the group members against which insolvency proceedings had commenced, but in some cases might extend to a solvent group member, where the affairs of that member were so closely intermingled with those of other group members that it would be beneficial to include it in the consolidation. It may even extend to individuals, such as the controlling shareholder. While typically requiring a court order, consolidation may also be possible on the basis of consensus of the relevant interested parties or by way of an approved reorganization plan.

24. Few jurisdictions provide statutory authority for consolidation orders,⁸ and where the remedy is available, in general it is not widely used. Notwithstanding the

⁷ New Zealand Companies Act 1993, Sections 271 (1)(a) and 272 (1).

⁸ Ibid., s272.

absence of direct statutory authority or a prescribed standard for the circumstances in which such orders can be made, the courts of some jurisdictions have played a direct role in developing these orders and delimiting the appropriate circumstances. This practice reflects increased judicial recognition of the widespread use of interrelated corporate structures for taxation and business purposes. As is the case with contribution orders, the circumstances that would support a consolidation order are very limited and tend to be those where because of a high degree of integration of the members of a corporate group, whether through control or ownership, it would be difficult, if not impossible, to disentangle the assets and liabilities of the different group members and administer the estate of each debtor separately.

25. Consolidation is typically discussed in the context of liquidation and the legislation that does authorize such orders does so only in that context. There are, however, legislative proposals that would permit consolidation in the context of various types of reorganization. In jurisdictions without specific legislation, consolidation orders may be available in both liquidation and reorganization, where such an order would, for example, assist the reorganization of the group.

26. Consolidation might be appropriate where it leads to greater return of value for creditors, either because of the structural relationship between the members of the group and the manner in which they conduct their business and financial relationships or because of the value of assets common to the whole group, such as intellectual property in both a process conducted across numerous group members and the product of that process. A further situation might be where there is no real separation between the members of a group, the group structure being maintained solely for dishonest or fraudulent purposes. Since intra-group trading is increasingly a norm of commercial activity, consolidation could enable an insolvency representative to focus on the external debts of the group where intra-group debts disappeared as a result of consolidation (discussed further below).

27. The principal concerns with the availability of such orders, in addition to those associated with the fundamental issue of overturning the separate entity principle, include, as already noted, the potential unfairness caused to one creditor group when forced to share *pari passu* with creditors of another group member that may be less solvent and whether the savings or benefits to the collective class of creditors outweighs incidental detriment to individual creditors. Creditors opposing consolidation could argue that as they relied on the separate assets of a particular group member when trading with it, they should not be denied a full payout because of their trading partner's relationship with another member of the same group. Creditors supporting consolidation could argue that they had relied upon the assets of the whole group and that it would be unfair if they were limited to recovery against the assets of a single group member.

28. Because it involves pooling the assets of different group members, consolidation may not lead to increased recovery for all creditors, but rather operate to level the recoveries across all creditors, increasing the amount distributed to some at the expense of distributions to others. Additionally, the availability of consolidation may enable stronger, larger creditors to take advantage of assets that do not and should not properly be available to them; encourage creditors who disagree with such an order to seek review of the order, thus prolonging the insolvency proceedings; and damage the certainty and foreseeability of security interests (where intra-group claims disappear as a result of consolidation, creditors that have security interests in those claims will lose their rights).

(b) Circumstances supporting consolidation

29. A number of elements have been identified as relevant to determining whether or not substantive consolidation is warranted, both in the legislation that authorizes consolidation orders and where the courts have played a role in developing these orders. In each case it is a question of balancing the various elements; no single element is necessarily conclusive and all of the elements do not need to be present in any given case. The elements include: the presence or absence of consolidated financial statements for the group; the use of a single bank account for all group members; the unity of interests and ownership between the group members; the degree of difficulty in segregating individual assets and liabilities; sharing of overhead, management, accounting and other related expenses among different group members; the existence of intra-group loans and cross-guarantees on loans; the extent to which assets were transferred or funds shifted from one member to another as a matter of convenience without observing proper formalities; adequacy of capital; commingling of assets or business operations; appointment of common directors or officers and the holding of combined board meetings; a common business location; fraudulent dealings with creditors; the practice of encouraging creditors to treat the corporate group as a single entity, creating confusion among creditors as to which of the group members they were dealing with and otherwise blurring the legal boundaries of the group companies; and whether consolidation would facilitate a reorganization or is in the interests of creditors. A further factor supporting consolidation might be where the only way to determine the status of various intra-group debts, if a consolidation order were not made, would be through separate legal proceedings. Such proceedings would invariably increase the cost and length of the liquidation and deplete the funds otherwise available for creditors.

30. While these many factors remain relevant, some courts have started to focus on two factors in particular, namely, whether creditors dealt with the group as a single economic unit and did not rely on the separate identity of individual group members in extending credit, and whether the affairs of the group members are so intermingled that consolidation will benefit all creditors.

(c) Competing interests in consolidation

31. In addition to the competing interests of the creditors of different members of a corporate group, the competing interests of different types of creditor warrant consideration in the context of consolidation: of creditors and shareholders; of shareholders of the different group companies, and in particular those who are shareholders of some of the companies but not of others; and of secured and priority creditors of different members of a consolidated group.

(i) Owners and equity holders

32. Many insolvency laws adopt the general rule that the rights of creditors outweigh those of owners and equity holders, with owners and equity holders being ranked after all other claims in the order of priority for distribution. Typically, this results in owners and equity holders not receiving a distribution.⁹ In the corporate group context, the shareholders of some group members with many assets and few liabilities may receive a return when the creditors of other group members with fewer assets and more liabilities may not. If the general approach of ranking

⁹ UNCITRAL Legislative Guide, part two, chap. V, para. 76.

shareholders behind unsecured creditors were to be extended, in consolidation, to the group as a whole, all creditors could be paid before the shareholders of any group member received a distribution.

(ii) *Secured creditors*

33. With respect to secured creditors, both internal and external to the group, there is a question of how their rights should be treated in a consolidation. The Legislative Guide on Insolvency Law¹⁰ discusses the position of secured creditors in insolvency proceedings and adopts the approach that while as a general principle the effectiveness and priority of a security interest should be recognized and the economic value of the encumbered assets should be preserved in insolvency proceedings, an insolvency law may nevertheless modify the rights of secured creditors in order to implement business and economic policies, subject to appropriate safeguards.

34. Questions that might arise with respect to consolidation might include: whether a security interest over some or all of the assets of one group member could extend to include assets of another group member where a consolidation order was made or whether that security interest should be limited to the defined pool of assets upon which the secured creditor had originally relied; whether secured creditors with insufficient security could claim the remaining debt against the pooled assets as unsecured creditors; and whether internal secured creditors (i.e. creditors that are other members of the same group) should be treated differently to external secured creditors. One solution with respect to external secured creditors might be to exclude them from the process of consolidation, thus achieving what might be a partial consolidation. Individual secured creditors that relied upon the separate identity of group members, such as where they relied upon an intra-group guarantee, might require special consideration. Where encumbered assets are required for reorganization, a different solution might be possible, such as allowing the court to adjust the consolidation order to make specific provision for such assets. The interests of internal secured creditors also need to be considered; different approaches might include cancelling internal security interests, leaving the creditors with an unsecured claim, or modifying or subordinating those interests.

(iii) *Priority creditors*

35. Similar questions arise with respect to the treatment of priority creditors. Practically, they might benefit or lose from the pooling of the group's assets in the same way as other unsecured creditors. Where priorities, such as those for employee benefits or tax, are based on the single entity principle, a question arises as to how they should be treated across the group, especially where they interact with each other. For example, employees of a group member that has many assets and few liabilities will potentially compete with those of a group member in the opposite situation, with few assets and many liabilities if there is consolidation. While priority creditors generally might obtain a better result at the expense of unsecured creditors without priority, the different groups of those priority creditors might have to adjust any expectations that are based on the single entity principle.

¹⁰ Annex I of the UNCITRAL Legislative Guide sets forth the sections of the Guide addressing the treatment of secured creditors in insolvency proceedings.

(d) Inclusion of solvent group members in consolidation

36. As noted above, consolidation might be extended to include solvent members of a corporate group, either because that group member is covered by the insolvency proceedings or because the affairs of that member are so closely intermingled with those of other group members that it would be beneficial to include it in the consolidation. Where that occurs, the creditors of that solvent group member may have particular concerns and a limited approach might be taken so that the consolidation order extended only to the net equity of the solvent group member in order to protect the rights of those creditors.

(e) Notification of creditors

37. The potential impact of consolidation on creditor rights suggests that affected creditors should have the right to be notified of any application for consolidation and the right to object. The interests of individual creditors who may have relied upon the separate identity of each group member in their dealings with a group would have to be weighed against the overall benefit to be gained by consolidation. One issue to be considered is whether a single objection would be sufficient to prevent consolidation or whether consolidation could nevertheless be ordered. It may be possible, for example, to provide objecting creditors who will be significantly disadvantaged by the consolidation relative to other creditors with a substantially greater level of return than other unsecured creditors, thus departing from the strict policy of equal distribution. It may also be possible to exclude specific groups of creditors with certain types of contracts, for example limited recourse project financing arrangements entered into with clearly identified group members at arm's length commercial terms.

(f) Other issues: timing and inclusion of additional group members over time

38. Additional issues to be considered with respect to consolidation orders include the timing of such an order (whether it could only be made at an early stage of the proceedings or later when it emerged that to do so would enhance the value to be distributed to creditors) and whether an additional group member could be added to an existing consolidation. If the consolidation order is made with the consent of the creditors, or if creditors are given the opportunity to object to a proposed order, the addition of another group member at a later stage of the proceedings has the potential to vary the pool of assets from what was originally agreed or notified to creditors. In that situation, it is desirable that creditors have a further opportunity to consent or object to the addition to the consolidation.

Recommendations*Consolidation*

(21) The insolvency law may permit the court to order insolvency proceedings against two or more members of a corporate group to proceed together as if they were a single entity in appropriate circumstances. In deciding whether appropriate circumstances exist, the court may consider:

(a) The extent to which there was such an intermingling of assets between the group members that it was impossible to disentangle the ownership of individual assets;

- (b) The extent to which creditors had dealt with the members of a corporate group as a single economic unit and did not rely upon their separate identity in extending credit;
- (c) The extent to which consolidation would benefit all creditors; and
- (d) [...].

Notes on recommendations

39. At its thirty-first session, the Working Group agreed that consolidation might be appropriate in certain limited circumstances and that judges would need clear criteria against which to assess the relevant issues.¹¹ Recommendation (21) recognizes that a court may order consolidation in appropriate circumstances and indicates some of the criteria that might be relevant to determining whether those circumstances exist in a particular case. A number of additional examples of potentially appropriate circumstances are outlined in paragraph 29 above.

D. Reorganization

[Reference: Legislative Guide, Part two, chap. IV and recommendations 139-159]

40. The Legislative Guide includes a detailed treatment of issues relevant to reorganization and the negotiation, approval and implementation of a reorganization plan.¹² Many of the issues discussed and the recommendations will apply to the reorganization of two or more members of a corporate group. One issue not considered is whether a single reorganization plan can be proposed for two or more members of a group.

41. Where reorganization proceedings are commenced against two or more members of a group, irrespective of whether or not those proceedings can be jointly administered, there is a question of whether it will be possible to reorganize the debtors through a single reorganization plan that has the potential to deliver savings across the group's insolvency proceedings, ensure a coordinated approach to the resolution of the group's financial difficulties, and maximise value for creditors. Several insolvency laws permit the negotiation of a single reorganization plan. Under some laws this approach is only possible where the proceedings are jointly administered or consolidated. Where that is not permitted, a unified reorganization plan would generally only be possible where the proceedings could, as a matter of practice, be coordinated.

42. If the insolvency law were to permit a unified reorganization plan, consideration would need to be given to the application of a number of the provisions of the Legislative Guide relating to reorganization of a single debtor to the case of a corporate group. Relevant provisions might include those relating to: parties competent to propose the plan or participate in its proposal;¹³ nature and content of a plan;¹⁴ safeguards concerning a plan;¹⁵ convening and conduct of

¹¹ Report of Working Group V (Insolvency Law) on the work of its thirty-first session, A/CN.9/618, paras. 37 and 42.

¹² UNCITRAL Legislative Guide, part two, chap. IV.

¹³ Ibid, paras. 8-14.

¹⁴ Ibid, paras. 3-5 and 17-25.

¹⁵ Ibid, paras. 54-63.

creditors meetings in respect of a plan; classification of claims and classes of creditors;¹⁶ voting of creditors and approval of a plan;¹⁷ objections to approval of the plan (or confirmation where it is required);¹⁸ and implementation of a plan.¹⁹

43. A single reorganization plan would need to take into account the different interests of the different groups of creditors, including the possibility that it might need to provide varying rates of return for the creditors of different group members. An appropriate balance between the rights of those different groups of creditors with respect to approval of the plan, including appropriate majorities, both within the creditors of a single group member and between creditors of different group members would also need to be achieved. For example, would rejection by the creditors of one of several group members mean the plan could not go ahead? One approach might be based upon provisions applicable to the approval of a reorganization plan for a single debtor. Another approach might be to devise different majority requirements that are specifically designed to facilitate approval in the group context. Safeguards analogous to those in recommendation 152 of the Legislative Guide could also be included, with an additional requirement that the plan should be fair as between the creditors of different group members.

44. Recommendation 152 of the Legislative Guide provides:

Confirmation of an approved plan

152. Where the insolvency law requires court confirmation of an approved plan, the insolvency law should require the court to confirm the plan if the following conditions are satisfied:

(a) The requisite approvals have been obtained and the approval process was properly conducted;

(b) Creditors will receive at least as much under the plan as they would have received in liquidation, unless they have specifically agreed to receive lesser treatment;

(c) The plan does not contain provisions contrary to law;

(d) Administrative claims and expenses will be paid in full, except to the extent that the holder of the claim or expense agrees to different treatment; and

(e) Except to the extent that affected classes of creditors have agreed otherwise, if a class of creditors has voted against the plan, that class shall receive under the plan full recognition of its ranking under the insolvency law and the distribution to that class under the plan should conform to that ranking.

45. An insolvency law might also include provisions addressing the consequences of failure to approve such a reorganization plan as addressed by recommendation 158, especially where solvent members of a corporate group can be included in the plan. One law, for example, provides that the consequence of failure to approve a plan is the liquidation of all insolvent members of the group.

¹⁶ Ibid, paras. 27, 36-37, 41-43.

¹⁷ Ibid, paras. 27-51.

¹⁸ Ibid, paras. 53-63.

¹⁹ Ibid, paras. 69-71.

46. Recommendation 158 of the Legislative Guide provides:

Conversion to liquidation

158. The insolvency law should provide that the court may convert reorganization proceedings to liquidation where:

- (a) A plan is not proposed within any time limit specified by the law and the court does not grant an extension of time;*
- (b) A proposed plan is not approved;*
- (c) An approved plan is not confirmed (where the insolvency law requires confirmation);*
- (d) An approved or a confirmed plan is successfully challenged; or*
- (e) There is substantial breach by the debtor of the terms of the plan or an inability to implement the plan.*

Recommendations

Unified reorganization plan

(22) The insolvency law may permit the proposal of a unified reorganization plan for two or more members of a corporate group that are subject to insolvency proceedings.

(23) The insolvency law may provide that a solvent member of the corporate group that is not subject to the insolvency proceedings can be included in a unified reorganization plan where the court determines that inclusion to be in the interests of the corporate group.

Notes on recommendations

47. Recommendations (22) and (23) outline the basic principles that an insolvency law may permit the proposal of a unified reorganization plan covering two or more members of a group against which insolvency proceedings have commenced and that a solvent member of the group not included in those insolvency proceedings may nevertheless be included in the plan where to do so would be in the interests of the group.

48. Taking into consideration the discussion included in paragraphs 42-44 above, the Working Group may wish to consider including additional recommendations addressing issues of content, in particular the extent to which it might be possible or necessary to allow different rates of return to be provided for different groups of creditors; approval; protections; failure of implementation; and other issues included in recommendations 139-159 of the Legislative Guide.

E. Other issues

49. In addition to the issues included above, the Working Group may wish to consider the following questions that have not yet been discussed:

- (a) The application of recommendations 69-86 of the Legislative Guide, which address the treatment of contracts, in the case of insolvency of two or more

members of a corporate group, particularly where those contracts were entered into between group members;

(b) Particular considerations that would apply to creditor participation in insolvency proceedings in a corporate group context where one or more of the creditors might be members of the same group and may or may not be subject to the same insolvency proceeding;

(c) The possibility of establishing a single creditor committee for each member of the group or each type of creditor across a group;

(d) With respect to creditor representation, special considerations that might apply to the application of recommendations 126-136 of the Legislative Guide, which address creditor participation. Members of a group that are creditors of other members of the group presumably would be considered to be related parties for the purpose of 131 and therefore disqualified from participating in creditor committees;

(e) The application of recommendations 137-138 of the Legislative Guide, which address rights of parties in interest to be heard and to appeal, to a member of a corporate group: "party in interest" as explained in the Legislative Guide would include a member of a corporate group in various possible ways, whether as a fellow debtor in joint proceedings, as a creditor, an equity holder, or simply as another member of the same group;

(f) Special considerations that might apply to submission of claims by other members of the same group, such as special scrutiny as claims by related persons under recommendation 184 of the Legislative Guide.

[IV. *International Issues is contained in A/CN.9/WP.76/Add.2*]

A/CN.9/WG.V/WP.76/Add.2 [Original: English]**Note by the Secretariat on the treatment of corporate groups in insolvency,
submitted to the Working Group on Insolvency Law at its thirty-second session****ADDENDUM****CONTENTS**

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IV. International issues**A. Introduction**

1. The Working Group may wish to consider whether the background material contained in paragraphs 1-4 of document A/CN.9/WG.V/WP.74/Add.2 could form the basis of an introduction to this chapter on international issues.

B. Jurisdiction to commence insolvency proceedings: Centre of main interests (COMI)

2. The UNCITRAL Legislative Guide notes¹ that a debtor must have a sufficient connection to a State to be subject to its insolvency laws. In many cases, no issue as to the applicability of the insolvency law will arise as the debtor will be a national or resident of the State and will conduct its economic activities in the State through a legal structure registered or incorporated in the State. However, where there is a question of the debtor's connection with a State, insolvency laws adopt different tests, including whether the debtor has its centre of main interests in the State, whether the debtor has an establishment in the State or whether it has assets in the State.

3. Although both the European Council (EC) Regulation No. 1346/2000 of 29 May 2000 on insolvency proceedings (the EC Regulation) and the UNCITRAL Model Law on Cross-Border Insolvency (the Model Law) use the concept of COMI, with respect to commencement of proceedings in the case of the Regulation and the provision of assistance in the case of the Model Law, it is not defined in either text. Both, however, provide a presumption that a debtor's COMI is the registered office, or habitual residence in the case of an individual, unless it can be shown that it is elsewhere.

4. Although applicable to countries subject to the EC Regulation or that have adopted the Model Law, the concept of COMI is not universal and where it is used, is a developing concept. Moreover, neither the Regulation nor the Model Law specifically address the concept of COMI as it might apply to a corporate group, although a number of cases have considered issues such as the integration of companies in a group in the context of considering whether the presumption that the debtor's COMI is its registered office can be displaced in a given case.

5. Factors identified as relevant to the rebuttal of the presumption, have included: the extent of a subsidiary's independence with respect to financial, management and policy decision-making; financial arrangements between parent and subsidiary, including capitalization, location of bank accounts and accountancy services; the division of responsibility with respect to provision of technical and legal documentation and signature of contracts; the location where design, marketing, pricing, delivery of products and office functions were conducted.

6. If the test of COMI were to be adopted universally, in practice, the COMI of each member of a corporate group, based on the treatment of individual members as separate legal entities, could be located in a different jurisdiction, leading to insolvency proceedings being commenced in each of those jurisdictions. In that scenario, coordination and cooperation between the different proceedings would be essential to ensure a successful resolution of the groups' insolvency.

7. Achieving a coordinated result for the insolvency of one or more members of a corporate group located in different States depends upon whether the different proceedings against each member can be recognized in other jurisdictions and whether parties involved in the various proceedings can cooperate and coordinate with each other. In those States that have adopted the UNCITRAL Model Law on

¹ UNCITRAL Legislative Guide, part two, chap. I, para. 12.

Cross-Border Insolvency,² the answer should be relatively straightforward; proceedings commenced where the debtor has its COMI could be recognized as foreign main proceedings, while proceedings commenced where the debtor has an establishment could be recognized as non-main proceedings and the effects of recognition provided by the Model Law would apply.³ Where the Model Law has not been adopted, however, reference must be had to national laws, many of which do not contain provisions equivalent to those provided in the Model Law with respect to recognition, assistance, cooperation or coordination.⁴ Because of the absence of such provisions, achieving a coordinated result can be time-consuming, costly and, in some cases, impossible.

8. For those reasons, coordination of international insolvency proceedings has been greatly facilitated in recent years by practices and procedures developed by insolvency professionals and courts, starting with individual cases and the need to address particular issues faced by the parties. Agreements or “protocols” have been negotiated by the parties and approved by the courts in the jurisdictions involved. Those cross-border insolvency protocols cover a number of issues, including, for example, settling a particular dispute arising from the different laws in concurrent cross-border proceedings, creating a legal framework for the general conduct of the case and coordinating the administration of an insolvent estate in one State with an administration in another State.

9. The Working Group may wish to note the progress with work being undertaken by the UNCITRAL secretariat through informal consultations with judges and insolvency practitioners to compile practical experience with respect to negotiating and using cross-border insolvency protocols.⁵ A report is being prepared on the development of that work (A/CN.9/629) for consideration by the fortieth Commission in 2007.

10. As an alternative to multiple proceedings, it might be possible in some cases to bring together insolvency proceedings against different group members. The insolvency proceedings might be conducted in or coordinated from a single jurisdiction or some form of joint administration might be possible (see below). Identifying the jurisdiction most central for a corporate group might be assisted by developing a concept of a “corporate group COMI”; or developing a rule deeming the COMI of the group to be, for example, the place of registration of the parent of the group or the place where it conducts its business activities. The extent to which those approaches could be achieved would depend upon widespread acceptance of a single standard or rule and agreement on what might constitute a “corporate group” for the purposes of such a rule.

11. Establishing the concept of COMI for a corporate group would be of particular relevance in cases where there was a high degree of integration between members of

² Adopted in British Virgin Islands, overseas territory of the United Kingdom of Great Britain and Northern Ireland (2005), Eritrea, Great Britain (2006), Japan (2000), Mexico (2000), Montenegro (2002), Poland (2003), Romania (2003), Serbia (2004), South Africa (2000) and United States of America (2005).

³ See UNCITRAL Model Law on Cross-Border Insolvency: art. 17 on decision to recognize and arts. 20 and 21 on effects of recognition.

⁴ For an analysis of the law of 39 jurisdictions, see “Cross-Border Insolvency: A Guide to Recognition and Enforcement”, INSOL International, 2003.

⁵ See *Official Records of the General Assembly, Sixty-first session, Supplement No. 17* (A/61/17), para. 209 for the decision of the Commission to undertake this work.

a corporate group and the group was run essentially as a single entity, with the activities of the group centralized at the COMI. The concept could be defined by reference to, for example, the issues discussed in para. 5 above, such as how and where policy, management and financial decisions of the group were made and third party perceptions, particular those of creditors, concerning that location. The COMI would determine the jurisdiction in which insolvency proceedings against a corporate group could be commenced and the law that would apply to commencement and administration of the proceedings.

12. Where the adoption of such an approach depended on close integration of the group, the requisite level of integration would need to be defined. Creditors would be required to investigate the connections of a company with which they dealt to ascertain whether or not it was part of a group. Such an approach may lead to a disconnection between the place of business of a member of a corporate group and the place in which insolvency proceedings could be commenced against that member. Additional proceedings might still be required in the jurisdiction away from the COMI in which group members conducted their businesses and held their assets.

13. Where such an approach relied upon a consideration of different factors to determine the COMI of the group it would not always be possible to ascertain that location before the insolvency proceedings actually commenced. A rule deeming the COMI to be in a specific location would create more certainty. A further issue would arise however with respect to widespread recognition and enforcement of such a rule and the decisions made in pursuance of it. Even if one court took the view that the COMI of the corporate group fell under its jurisdiction and it could therefore hear applications with respect to other members of that group, other courts would not necessarily concur with that decision in the absence of a binding obligation to do so. This could lead to competing and overlapping claims. In addition, different views might be taken with respect to the inclusion of an enterprise in a corporate group, particularly an international corporate group; for example, some courts might regard as a subsidiary what others might regard as a domestic company, notwithstanding its connection to members of a group located elsewhere. A further consideration would be the extent to which the determination that the COMI of a number of group members was found to be in one jurisdiction, would disadvantage creditors, including employees, who were located in jurisdictions different to that of the COMI, with respect, for example to filing claims, participating in creditor committees and participating at hearings.

14. A further approach, as noted above, could be to deem the COMI of the group to be that of the parent of a corporate group, so that all other group members would also have that COMI and jurisdiction for commencement of proceedings would not be related to place of incorporation or registered office, except as it related to the parent where that was a determinant of COMI. Difficulties might arise, however, where the parent was not insolvent but group members located elsewhere were insolvent.

15. Applicable on a regional basis, the Transnational Insolvency: Principles of Cooperation among NAFTA Countries⁶ recommend two rules concerning subsidiaries in the context of corporate groups. The first⁷ is that a subsidiary should

⁶ Developed by The American Law Institute, 2003 as part of its Transnational Insolvency project, available at www.ali.org.

⁷ Procedural Principle 23: Coordination with Subsidiaries.

be permitted to apply for insolvency in the jurisdiction in which the parent's insolvency proceedings have commenced so that reorganization can be administered on a group basis. The possibility of parallel proceedings is acknowledged, in which case coordination should facilitate achievement of the benefits of consolidation as far as possible. The second recommendation⁸ is that corporate groups should be reorganized from a global perspective, subject to the necessity of allocating value with regard to the corporate form. The principles provide an exception for those situations where either the main jurisdiction or the subsidiary's jurisdiction require insolvency as a condition of making an application for commencement of proceedings or the court of the main proceeding will not ordinarily accept jurisdiction over a company that is not registered and does not do business in that country, which will often be true of the subsidiary.

16. At its thirty-first session,⁹ the Working Group acknowledged that the difficulties in achieving an agreed definition of the concept of COMI suggested the need to focus on facilitating coordination and cooperation between the various courts in which insolvency proceedings against different members of a corporate group might be commenced, while acknowledging the desirability of avoiding a multiplicity of proceedings in the corporate group context.

17. The Working Group may wish to consider the issue of commencement of insolvency proceedings in the group context further in light of the discussion outlined above and the discussion of joint administration and reorganization below. The Working Group might wish to consider, for example, the possibility of supplementing the provisions of the UNCITRAL Model Law on Cross-Border Insolvency to specifically address coordination and cooperation in the context of corporate groups. Those provisions might include, for example, facilitation of joint administration and approval of unified reorganization plans.

C. Treatment of assets on commencement of insolvency proceedings

1. Joint administration

18. As noted above with respect to the domestic context,¹⁰ joint administration has the potential to facilitate the conduct of insolvency proceedings by reducing costs and delays. It also has this potential in the cross-border context. However, while in the domestic context there might be procedures that would enable proceedings commenced in different jurisdictions to be brought together, those procedures generally do not exist at the international level, although a practice of facilitating

It should be permissible to file bankruptcy for a subsidiary in the same jurisdiction as the parent's bankruptcy, and to have either procedural or substantive consolidation under applicable law, absent a proceeding involving the subsidiary in the country of its main interests. Where the subsidiary is in a parallel proceeding in the country of its main interests, coordination between the two proceedings should achieve the benefits of consolidation where possible.

⁸ Procedural Principle 24: Principles as Applied to Subsidiaries

The principles of coordination and cooperation should include parallel proceedings involving a subsidiary of a foreign parent debtor to the same extent as with parallel proceedings involving the debtor, although certain decisions, such as allocation of value, may be differently determined because of the need to honour the corporate form.

⁹ Report of Working Group V (Insolvency Law) on the work of its thirty-first session, A/CN.9/618, para. 54.

¹⁰ A/CN.9/Working Group.V/WP.76, paras. 32-37.

joint administration does exist between some neighbouring jurisdictions.¹¹ At the international level, proceedings in different jurisdictions involve diversity of assets, creditors, laws, and priorities, as well as questions concerning choice of the jurisdiction from which joint administration should be conducted, the treatment that might be applicable to solvent members in different jurisdictions and the ability of the insolvency representatives to operate in different jurisdictions, particularly those in which they are not qualified under the relevant law.

19. In some situations there might be a need for parallel proceedings to address some of these issues, although in general a multiplicity of proceedings should be avoided in order to facilitate coordination and cooperation. Joint administration, which does not require a formal decision with respect to a group's centre of main interests, would be facilitated by adoption of the UNCITRAL Model Law, to provide a legislative framework for cross-border cooperation and communication, and the use of cross-border protocols or other mechanisms to address procedural and administrative issues arising between the different jurisdictions.

2. Post-commencement finance

20. The Working Group may wish to consider whether paragraphs 15-22 of A/CN.9/WG.V/WP.74/Add.2 could be revised to form the commentary for this section on post-commencement finance.

Recommendations

Attracting and authorizing post-commencement finance for an international corporate group

(24) The insolvency law should enable an international corporate group [or any member of the group] to obtain post-commencement finance under the circumstances and standards set forth in recommendations 26 to 32, below.

(25) The insolvency law should facilitate and provide incentives for post-commencement finance to be obtained by the insolvency representative of any member of an international corporate group where the insolvency representative determines it to be necessary for the continued operation or survival of the business of the international corporate group [or any of its members], or the preservation or enhancement of the value of the estates of one or more members of the group. The insolvency law may require either the court with jurisdiction over any affected member of the group to authorize, or the creditors of any affected member of the group, to consent to the provision of post-commencement finance to such affected member of the group, as specified in recommendations 31 and 32, below.

(26) The insolvency law should permit a debtor that is a member of an international corporate group to receive the proceeds of post-commencement finance obtained by another member or members of such group.

Guarantee or other assurances for repayment of post-commencement finance for an international corporate group

(27) The insolvency law should specify that a member of an international corporate group [that is a debtor] may guarantee or provide other assurance of repayment for post-commencement finance obtained by another member of the international

¹¹ For example, Canada and the USA.

corporate group provided the court with jurisdiction over the debtor-guarantor determines that:

(a) [The estate of] the debtor-guarantor would receive benefits from such post-commencement finance comparable to those received by the obtainer of the post-commencement finance; or

(b) The [creditors] [insolvency representative] of the debtor-guarantor consent to the provision of that guarantee or other assurance of repayment; or

(c) The creditors of the debtor-guarantor would suffer no economic harm as a result of such guarantee or other assurance of repayment.

Priority for post-commencement finance for an international corporate group

(28) The insolvency law should establish the priority that may be accorded to post-commencement finance provided to a member of an international corporate group, provided the court with jurisdiction over that member ensures at least the payment of the post-commencement finance provider ahead of the ordinary unsecured creditors of that member, including those unsecured creditors with administrative priority.

Security for post-commencement finance for an international corporate group

(29) The insolvency law should enable a member of an international corporate group to grant a security interest for repayment of post-commencement finance provided to that member of the group, including a security interest on an unencumbered asset, including an after-acquired asset, or a junior or lower priority security interest on an already encumbered asset of the estate of that member of the group.

(30) The insolvency law should enable a member of an international corporate group to grant a security interest for repayment of post-commencement finance provided to another member of the group, including a security interest on an unencumbered asset, including an after-acquired asset, or a junior or lower priority security interest on an already encumbered asset of such grantor.

(31) The law should¹² specify that a security interest over the assets of the estate of any member of an international corporate group granted to secure post-commencement finance for any member(s) of the group does not have priority ahead of any existing security interest over the same assets unless the insolvency representative [of each affected member of the group] obtains the agreement of existing secured creditor(s) or follows the procedure in recommendation 32.

(32) The insolvency law should specify that, where any existing secured creditor does not agree [that post-commencement finance should be accorded a priority senior to its security interest], the court with jurisdiction over the member of the group that is subject to the existing security interest may authorize the creation of a security interest having priority over pre-existing security interests provided specified conditions are satisfied, including:

(a) The existing secured creditor was given the opportunity to be heard by the court;

¹² This rule may in a law other than the insolvency law, in which case the insolvency law should note the existence of the provision.

(b) It can be proven that the affected member(s) of the international corporate group cannot obtain the finance [in any other way] [on more favourable terms and conditions]; and

(c) The interests of the existing secured creditor will be protected.

Notes on recommendations

21. These recommendations are based upon recommendations 63 to 67 of the Legislative Guide and recommendations 13 to 19 of A/CN.9/WG.V/WP.76 with respect to post-commencement finance for a corporate group in a domestic context.

22. The notes in paragraphs 58 to 61 of A/CN.9/WG.V/WP.76 with respect to draft recommendations 13 to 19 would apply also to these draft recommendations.

23. Recommendation 26 permits one member of a corporate group to receive post-commencement finance obtained by another member of the same group, where those members might be in different jurisdictions and finance could not be provided in that situation without specific legislative authorization.

24. Recommendations 29 and 30 are based on recommendation 17, but deal respectively with a security interest provided by the group member receiving the finance and by a group member other than the group member receiving the finance, where those members may be located in different jurisdictions.

25. As noted above with respect to post-commencement finance in a domestic context, recommendation 68 of the Legislative Guide, which seeks to preserve the priority afforded to post-commencement finance, would be relevant where reorganization proceedings against a member or members of a corporate group are converted to liquidation.

D. Remedies: Substantive consolidation

26. As discussed in the domestic context,¹³ where a group is closely integrated and assets and liabilities belonging to each group member cannot be easily identified, cross-border substantive consolidation might facilitate the administration of group proceedings. Consideration of this remedy in a cross-border case is, however, much more complex than in a domestic setting, since it raises issues relating to: applicable insolvency law; the extent to which courts could waive rules in a cross-border situation that would be applied in a domestic case; applicable avoidance rules; negotiation, approval and implementation of a single reorganization plan; applicable rules on recognition of claims and distribution; treatment of security interests; and so forth.

27. Consolidation in cross border cases is not common. There are, however, examples of cases where the insolvency of a closely integrated group involving subsidiaries in different jurisdictions has been administered as if it were a single entity with the consent of creditors, as well as examples involving a unified reorganization plan.

¹³ A/CN.9/WG.V/WP.76/Add.1, paras. 23-39.

E. Reorganization: Unified reorganization plans

28. As noted above in the domestic context,¹⁴ the ability to negotiate a single reorganization plan has the potential to facilitate reorganization of a corporate group in several ways. This is also true in the international context, although different considerations will apply, including how different requirements with respect to proposal and approval of a reorganization plan in different jurisdictions could be satisfied in the case of a single plan and whether a reorganization plan approved in one jurisdiction could be recognized or regarded as binding in another.

29. A unified reorganization plan might be possible in those cases where the laws concerning negotiation and approval of a plan in the relevant jurisdictions are not significantly different or where the differences between those laws can be resolved by way of a protocol. One approach, at a regional level, is proposed by *The Principles of Cooperation among NAFTA Countries*,¹⁵ which address the possibility of making a reorganization plan approved in a main proceeding binding in non-main proceedings, provided certain safeguards are met.

“Recommendation 5: Binding Effect of Plans

The NAFTA countries should adopt provisions requiring approval of main-proceeding reorganization plans by courts in non-main proceedings despite a lack of compliance with rules for approval of such plans under domestic law if (a) the plan distribution will include significant value from assets or operations from outside the approving country; (b) the plan has been approved under the voting requirements of the law of the main proceeding; (c) creditors and other interested parties from the approving country have had a fair and reasonable opportunity to participate in the main proceeding; and (d) the plan does not discriminate unfairly on the basis of national citizenship, residence, or domicile. The provisions should also make such a plan final and binding in the approving country on the rights of all parties interested in the debtor’s affairs to the same extent as it is under the law of the main proceeding.”

30. Where there is only a main proceeding, and no parallel proceedings within NAFTA, the Principles provide, firstly, that the plan should be final and binding upon the debtor and upon every creditor who participates in any way in the main proceeding. For this purpose, participation includes filing a claim; voting; or accepting a distribution of money or property under a plan.¹⁶ The Principles provide further that the plan should also be final and binding as to the claims against the debtor of every unsecured creditor who was given adequate individual notice of the case; and who would be considered within the jurisdiction of the courts in ordinary commercial matters under the law of the country of the main proceeding, with respect to the type of claims asserted by that creditor.¹⁷

31. The operation of those Principles would mean that every creditor that participated in the specified manner in the main proceedings could be bound by the plan approved in those proceedings even if they did not support the plan, as could any creditor that was notified of the proceedings and had sufficient contacts with the

¹⁴ A/CN.9/WG.V/WP.76/Add.1, paras. 40-43.

¹⁵ See note 6 above and also paragraph 15 above.

¹⁶ Procedural Principle 26: Plan Binding on Participant.

¹⁷ Procedural Principle 27: Plan Binding: Personal Jurisdiction.

country of the main proceeding to make the operation of its insolvency jurisdiction over that creditor reasonable.

32. The Working Group may wish to consider how the proposal and approval of a unified reorganization plan might be facilitated, in addition to draft recommendations 22 and 23 which apply in a domestic context, in a cross-border insolvency context.

F. Other issues: Conflicts of laws

33. The Working Group may wish to recall the discussion of conflict of laws issues in the context of the Legislative Guide¹⁸ and consider the extent to which conflict of laws issues as they relate to the insolvency of international corporate groups could be addressed in future work on corporate groups.

¹⁸ UNCITRAL Legislative Guide, part two, chap. I, paras. 80-91 and recommendations 30-34.

VI. POSSIBLE FUTURE WORK

A. Note by the Secretariat on possible future work on security rights in intellectual property (A/CN.9/632) [Original: English]

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I. Introduction

1. At its thirty-ninth session, in 2006, the Commission on International Trade Law (UNCITRAL) approved in principle the substance of the recommendations of the draft UNCITRAL legislative guide on secured transactions (the “draft guide”).¹ At that session, the Commission noted that intellectual property (e.g. copyrights, patents or trademarks) was increasingly becoming an extremely important source of credit and should not be excluded from a modern secured transactions law. In that connection, it was stated that financing transactions with respect to equipment or inventory often included security rights in intellectual property as an essential and valuable component. It was also observed that significant financing transactions involving security rights in all the assets of a grantor would typically include intellectual property.²

2. In addition, the Commission noted that the recommendations of the draft guide generally applied to security rights in intellectual property to the extent they were not inconsistent with intellectual property law (see A/CN.9/631, recommendation 4, subpara. (b)). Moreover, the Commission noted that, as the recommendations had not been prepared with the special intellectual property law issues in mind, the draft guide generally recommended that enacting States might consider making any necessary adjustments to the recommendations to address those issues.³

¹ *Official Records of the General Assembly, Sixty-first Session, Supplement No. 17 (A/61/17)*, paras. 13-78.

² *Ibid.*, para. 81.

³ *Ibid.*, para. 82.

3. Moreover, in order to provide guidance to States in that regard, the Commission requested the Secretariat to prepare, in cooperation with other organizations and in particular the World Intellectual Property Organization (WIPO), a note discussing future work by the Commission on security rights in intellectual property. The Commission also requested the Secretariat to organize a colloquium on security rights in intellectual property.⁴

4. The UNCITRAL Second International Colloquium on Secured Transactions: Security Interests in Intellectual Property Rights (hereinafter the “Colloquium on Security Interests in Intellectual Property Rights”) was held in Vienna on 18 and 19 January 2007. At the Colloquium, several issues were raised with respect to the treatment of security rights in intellectual property in the draft guide.⁵ It was widely felt that some of those issues could be addressed by clarifying the text of certain definitions and recommendations of the draft guide without changing policy decisions made by the Commission and Working Group VI (Security Interests), while other issues required more substantial work and adjustments to the asset-specific part of the draft guide.

5. At its twelfth session (New York, 12-16 February 2007), Working Group VI revised several recommendations and definitions to address those issues that could be addressed with minor adjustments and clarifications (see A/CN.9/620, paras. 111-120). At its eleventh and twelfth sessions, the Working Group considered and approved the recommendations of the draft guide, presented in two parts for each chapter, one part that highlighted the general recommendations or core principles for the benefit of all States, and another part that dealt with asset-specific principles and recommendations for the benefit of those States which might not need all the asset-specific recommendations (see A/CN.9/617 and A/CN.9/620).

6. The purpose of the present note is to address some of the issues that would require further work by the Commission and more significant adjustments to the asset-specific part of the draft guide, as a supplement to the draft guide for the benefit of those States which would need specific guidance with respect to security rights in intellectual property. The note is not intended to list all the issues in an exhaustive way or to discuss them in every detail. It briefly discusses some of the main issues that would need to be addressed with a view to reasonably establishing the desirability and feasibility of future work by the Commission.

7. The note first discusses briefly the importance of intellectual property as security for credit and the inadequacy of current laws (chap. II), and then summarizes the current treatment of security rights in intellectual property in the draft guide and suggests several adjustments that would need to be made to the asset-specific part of the draft guide (chap. III). The note concludes with the suggestions for future work on security rights in intellectual property (chap. IV).

II. Importance of intellectual property as security for credit and the inadequacy of current laws

8. With the advent of the information age and the rapid pace of technological development, intellectual property, such as patents, trademarks, copyrights,

⁴ Ibid., para. 86.

⁵ The papers presented at the Colloquium are available on the UNCITRAL website (www.uncitral.org/uncitral/en/commission/colloquia/2secint.html).

customer lists, know-how and trade secrets (for the definition of “intellectual property”, see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation), represents an increasingly significant component of the value of many businesses. Many of those businesses are engaged in developing, licensing, distributing and managing intellectual property and their principal assets consist of the intellectual property. In addition, other businesses, such as manufacturers, frequently utilize equipment that requires the use of patented technology for its operation and distributors often sell goods that derive a significant portion of their value from trademarks affixed to the goods or copyrighted material included in the packaging. All those businesses, including technology businesses that currently have resort only to investors as a source of capital, as well as more traditional companies that rely increasingly on the use of intellectual property in their businesses, would benefit from access to secured credit predicated upon the value of their intellectual property or their rights to use intellectual property of other persons.

9. Intellectual property is typically used as an encumbered asset in secured lending transactions in two primary ways. First, intellectual property frequently represents an intrinsic component of the value of other property owned by the grantor, such as goods that have been branded with a registered trademark or that incorporate copyrighted materials in their packaging. Such intellectual property may be owned by the grantor or licensed by the grantor from a third party pursuant to an exclusive or non-exclusive licence. In either case, the goods themselves may have little or no value to a lender as security unless applicable law would permit the lender to enforce its security rights in the goods in an efficient and cost-effective manner without infringing the intellectual property rights.

10. Second, intellectual property often has sufficient independent value so that a grantor is able to use it as security for credit. Examples would be the portfolio of patents owned by a pharmaceutical company or the trademarked name and logo of a well-known chain of retail stores. This is especially true for the growing number of companies in the technology sector. For example, an owner/licensor of computer software might seek to obtain a loan secured by the anticipated streams of royalty payments from its various licences. In these circumstances, the amount of credit that a lender is willing to extend and the interest and other compensation that the lender will require, will depend in part on the lender’s level of certainty that it will be able to look to the intellectual property and anticipated royalty payments under the various licences as a source for repayment of its loan.

11. In any case, clear and predictable laws are critical to enabling the lender to make this determination. As is the case with any asset that may be used as an encumbered asset for credit, law other than secured transactions law governs the exact nature or the extent of the asset. In the case of intellectual property, the asset is defined in the framework of national law and practice, as well as a number of international conventions that determine in the first instance what types of intellectual property may be encumbered and how. This framework is, in many cases, not coordinated with existing secured transactions laws, which are often based on principles applicable to tangible assets, such as inventory and equipment, or other types of intangible asset, such as receivables. In some jurisdictions, some aspects of security rights in certain types of intellectual property are governed by the intellectual property law (e.g. registration), while in other jurisdictions such rights are subject to a more complete coverage in the secured transactions law. The common result is that security rights in intellectual property are governed by both

sets of laws, often with some uncertainty as to the relationship between the two regimes.

12. Accordingly, there is a need for a careful coordination between the laws governing secured transactions (and, in the case of the grantor's insolvency, insolvency laws) and those governing intellectual property generally.⁶ This requires understanding the principles that support intellectual property commerce and identifying the extent to which they may differ from those supporting commerce for tangible goods and receivables.⁷

III. Asset-specific adjustments to the draft guide with respect to security rights in intellectual property

A. Terminology

13. The term “intellectual property” is defined in the draft guide as including “copyrights, trademarks, patents, service marks, trade secrets and designs and any other asset that is considered to be intellectual property under the domestic law of the enacting State or an international agreement to which it is a party” (see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation). The commentary makes reference to agreements, such as the Convention Establishing the World Intellectual Property Organization and the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS).⁸

14. With respect to other terms, the draft guide relies on terminology normally used in secured transactions legislation. While this approach may be adequate in some respects, it may require adjustments in other respects, because intellectual property law has its own terminology, which may not be fully consistent with the current terminology used in the draft guide.

15. For example, the draft guide uses the term “assignment” solely with respect to receivables (see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation). However, “assignment” has a broader meaning in intellectual property practice, involving a transfer of ownership in intellectual property and not merely the transfer of a receivable. Similarly, the draft guide does not define a “licence” and only refers to a licence in an undifferentiated sense without addressing the differences between exclusive licences and non-exclusive ones. In the same vein, the draft guide uses the term “retention of title” only with respect to tangible property. It does not refer to licences, which by definition involve the retention of title in intellectual property by the licensor (see para. 37 below).

⁶ For more information on the importance of intellectual property as security for credit and problems under current law, see “Intellectual property issues affecting a secured transactions regime”, submitted by the Commercial Finance Association in connection with UNCITRAL's development of a guide on secured transactions (August, 2004), available at www.uncitral.org/pdf/english/colloquia/2secint/Kohn.pdf.

⁷ For an analysis of the issues by a group of intellectual property law experts, see “Report and analysis of the Ad Hoc Working Group on Intellectual Property Financing regarding the UNCITRAL draft legislative guide on secured transactions” (January, 2007), available at www.uncitral.org/pdf/english/colloquia/2secint/Ad%20Hoc%20Working%20Group%20Report.pdf.

⁸ Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, annex IC (United Nations, *Treaty Series*, vol. 1867, No. 31874).

Furthermore, the draft guide does not provide terminology to identify the varying interests of owners, co-owners, joint authors and other parties involved in the initial development of intellectual property.

16. In addition, following the approach taken in most legal systems and reflected in the United Nations Convention on the Assignment of Receivables in International Trade⁹ (hereinafter the “United Nations Assignment Convention”), the draft guide does not differentiate trade receivables from income streams under licence agreements relating to intellectual property. As this approach is disputed in some intellectual property circles, the issue may need to be discussed (see para. 35 below).

17. Moreover, the draft guide does not define tangible property embodying in part intellectual property (e.g. trademarks of goods or software embedded in goods) or security rights in such property, nor discusses at any length the relevant issues. On the one hand, if a security right in such property did not extend to intellectual property embodied therein, the security right may be deprived of any meaning (where, for example, the encumbered asset is inventory of digital cameras operated by software on a chip). On the other hand, such a result may be incompatible with the right of the owner of the intellectual property to control the distribution of copies and goods embodying intellectual property and may have to be limited in line with applicable principles of intellectual property law (see paras. 38 and 39 below).

B. Scope

18. The law recommended in the draft guide should provide that it applies to “all types of movable property and attachment, tangible or intangible, present or future, including inventory, equipment and other goods, contractual and non-contractual receivables, contractual non-monetary obligations, negotiable instruments, negotiable documents, rights to payment of funds credited to a bank account, proceeds under an independent undertaking and intellectual property rights” (see A/CN.9/631, recommendation 2, subpara. (a)).

19. However, the law should provide that “notwithstanding recommendation 2, subparagraph (a), it does not apply to ... intellectual property to the extent that the provisions of this law are inconsistent with national law or international agreements, to which the State is a party, relating to intellectual property” (see A/CN.9/631, recommendation 4, subpara. (b)).

20. The commentary explains that a State enacting secured transactions legislation in accordance with the draft guide should consider whether it might be appropriate to adjust certain of the recommendations as they apply to security rights in intellectual property. Examples of such recommendations include recommendation 204 on the law applicable to security rights in intangible property, recommendations 43 and 83 on registration in a specialized registry, and recommendations raising the issue of whether a security right in goods extends to any intellectual property involved in their use or operation (see A/CN.9/631/Add.1).

21. In addition, the commentary draws the attention of States to the need to examine their existing intellectual property laws and the State’s obligations under intellectual property treaties, conventions and other international agreements and, in

⁹ United Nations publication, Sales No. E.04.V.14.

the event that the recommendations of the draft guide are inconsistent with any such existing laws or obligations, the State's secured transactions law should expressly confirm that those existing intellectual property laws and obligations govern such issues to the extent of the inconsistency. Moreover, the commentary clarifies that States may need to adjust certain recommendations of the draft guide to avoid inconsistencies with intellectual property laws and treaties (see A/CN.9/631/Add.1).

22. While the commentary encourages States to undertake an analysis of possible inconsistencies between intellectual property law and the draft guide, it does not provide specific guidance on where such inconsistencies may arise nor how recommendations in the draft guide should be adjusted to avoid them. Although the draft guide recommends that intellectual property law prevail over secured transactions law to the extent there are any inconsistencies between the two, there may be reluctance on the part of some States to apply any recommendations in the draft guide to intellectual property assets due to concerns about possible adverse domestic or international consequences from an erroneous application. This reluctance may in turn lead lenders to conclude that intellectual property assets are not an appropriate subject for secured financing, which can have undesired consequences given the increasingly important role of intellectual property in modern economies.

23. Future work by the Commission would provide specific guidance to States as to any adjustments that would need to be made in the asset-specific part of the draft guide to address issues arising in secured transactions relating to intellectual property and thus facilitate such transactions.

C. Creation of a security right

1. General approach of the draft guide

24. Under the draft guide, a security right is created by agreement between the grantor and the secured creditor (see A/CN.9/631, recommendation 12). To be effective, a security agreement must reflect the intent of the parties to create a security right, identify the secured creditor and the grantor and describe the secured obligation and the encumbered assets (see A/CN.9/631, recommendation 13). If not accompanied by a transfer of possession of the encumbered asset, the agreement must be concluded in or evidenced by a writing that, in conjunction with the course of conduct between the parties, indicates the grantor's intent to grant a security right. Otherwise, it may even be oral (see A/CN.9/631, recommendation 14).

25. The assets encumbered under the security agreement may be described in a generic way, such as "all present and future assets" or "all present and future inventory" (see A/CN.9/631, recommendation 13). The security right may secure any type of obligation, present or future, determined or determinable, as well as conditional and fluctuating obligations (see A/CN.9/631, recommendation 15). It may cover any type of asset, including assets that, at the time the security agreement is concluded, may not yet exist or that the grantor may not yet own or have the power to encumber (see A/CN.9/631, recommendation 16). Unless otherwise agreed by the parties to the security agreement, the security right in the encumbered asset extends to its identifiable proceeds (see A/CN.9/631, recommendation 18).

26. If the encumbered asset is a receivable, an assignment of the receivable is effective as between the assignor and the assignee and as against the debtor of

the receivable notwithstanding an agreement between the initial or any subsequent assignor and the debtor of the receivable or any subsequent assignee limiting in any way the assignor's right to assign its receivables (see A/CN.9/631, recommendation 22).

2. Possible asset-specific adjustments

27. The general provisions of the draft guide with respect to the creation of a security right may apply to security rights in intellectual property (see A/CN.9/631, recommendations 12-18). However, the application of certain provisions to security rights in intellectual property may need to be adjusted with asset-specific recommendations.

(a) Generic description of encumbered assets

28. For example, the concept of a generic description of the encumbered assets may need modification when applied to the registration of intellectual property in a specialized registry. A description that embraces "all rights" for a specific item of intellectual property may be "generic" for these purposes, such as "all rights in Patent B in Country X". However, a description of multiple items of intellectual property may need some identifying description for each item, such as "all motion pictures owned by Studio A identified by title on the attached schedule".

29. As discussed below (see para. 49), intellectual property registries index notices by the intellectual property, not the grantor. Thus, a notice that merely identified "all intellectual property owned by the grantor" would not contain a sufficient description. It would instead be necessary to identify each item of intellectual property by title or identification in the registered notice. For efficiency reasons, it might be appropriate to require the description of the encumbered assets in the security agreement to meet the same level of precision.

(b) Non-transferable obligations

30. Another example is the provision of the draft guide that, while a security right may secure any type of obligation (see A/CN.9/631, recommendation 15), the law recommended in the draft guide does not override statutory prohibitions to the transferability of specific types of asset, with the exception of prohibitions to the transferability of future receivables and the effectiveness of an assignment of receivables made despite an anti-assignment agreement (see A/CN.9/631, recommendation 17).

31. Further work would need to clarify that it is important to permit the party to whom the services in personal service contracts with authors or inventors are owed to create a security right in its rights to receive performance, as this will often be necessary to obtain financing. However, a blanket provision that allows such a party to create such a security right without consent of the party owing the performance of such services might be incompatible with existing laws. The impact of these matters on the ability of a party to create a security right in the right to receive performance under such personal service contracts may need further study.

(c) After-acquired assets

32. A further example is the provision of the draft guide that a security agreement may cover assets that may not exist at the time the security agreement is concluded

(“after-acquired” or “future assets”; see A/CN.9/631, recommendation 16). On the one hand, there is commercial utility in allowing a security right to extend to intellectual property to be later created or acquired. For example, in some States it is possible to create a security right in a patent application before the patent is issued. Similarly, it is common practice to fund motion pictures or software to be produced. An effective secured financing law should support such practices. On the other hand, many States limit transfers of various future intellectual property. Some States limit the ability to make effective transfers of rights in new media or technological uses that are unknown at the time of the grant. It may be necessary to adjust the draft guide to accommodate those rules.

(d) The *nemo dat* principle

33. Another example is the requirement that the grantor must have rights in the encumbered asset (the principle that no one can give what he or she does not have — *nemo dat quod non habet* or *nemo plus juris transferre potest quam ipse habet*), which has particular importance with respect to security rights by licensees (see A/CN.9/631, recommendation 13). Future work would need to clarify the application of the *nemo dat* principle to intellectual property, namely that a creditor obtaining a security right in intellectual property or rights to use intellectual property does not obtain any rights more than the rights that the grantor has in that intellectual property. In particular, if the grantor were a licensee, it would need to be confirmed that the licensee could not give anything more than the right granted to the licensee from the licensor. One of the effects of this result is that future work would need to reinforce the lender’s need to conduct appropriate due diligence to determine matters such as the extent of the licensee’s rights, the duration of those rights and the territories in which those rights may be exercised.

(e) The principle of party autonomy

34. Another example of an issue that might require further work is the provision of the draft guide recognizing party autonomy (see A/CN.9/631, recommendation 8). Further work on security rights in intellectual property should clarify that intellectual property owners have the right to decide which third parties may use the intellectual property and the conditions for so doing. In particular, intellectual property owners should have the right to transfer their rights or to give to another person a licence to use them.

(f) Anti-assignment agreements

35. In this connection, future work has to confirm the right of the licensor under law other than the secured transactions law to limit by contract the right of the licensee to transfer the licence or give a sub-licence to a third party, as well as the right of the licensor to terminate the licence for breach of contract. As a result, it should be made clear that the relevant provision of the draft guide with respect to anti-assignment agreements relating to receivables (see A/CN.9/631, recommendation 25) does not apply to the rights of licensees under intellectual property licences. However, in line with current law in most legal systems and the United Nations Assignment Convention, it does apply with respect to receivables arising from intellectual property (e.g. licence royalties). In this regard, intellectual property experts argue that receivables arising from intellectual property should be treated as forming part of the intellectual property. In support of their argument, they refer to case law, international conventions permitting transfers and licences of

intellectual property and restricting practices involving compulsory licences. They also refer to national laws, for example, imposing restrictions on the assignability of royalties payable to owners-licensors.

(g) Title to intellectual property

36. Another issue that should be addressed is who has title or the rights associated with title to intellectual property as an encumbered asset: the grantor or the secured creditor. For intellectual property, title determines important components of asset value, including the right to deal with governmental authorities for several purposes, such as for patent prosecutions, to grant licences and to pursue infringers. It is therefore important to determine whether the grantor or the secured creditor holds title to the intellectual property during the financing, as this will be important to both parties in order to preserve the value of the encumbered asset. Under the principle of party autonomy, the law should allow the parties to decide the matter for themselves in the security agreement. Where the agreement is silent, it may be necessary for a secured transactions law to be coordinated with the relevant rules of intellectual property law to ensure that the secured creditor does not have title to intellectual property as an encumbered asset (as is the case with any other encumbered asset). A possible approach may be to provide that, unless otherwise agreed, the secured creditor has no right to approve various types of licence.

(h) Retention of title by the licensor in a licence agreement

37. Yet another example is the provision of the draft guide that treats certain title-retention transactions as functionally equivalent to secured transactions, allowing a buyer of goods to create a security right in the goods even before the buyer pays the price in full and acquires title in the goods. A licence agreement involves permission to use intellectual property under the conditions set out in the licence agreement and the retention of title in the intellectual property by the licensor. Future work should clarify that such a transaction is not functionally equivalent to a secured transaction and the licensee does not automatically have the right to transfer the licence or give a sub-licence to a third party (for further discussion of this issue, see chap. III, sect. J, on acquisition financing, paras. 78-80 below).

(i) Tangible property embodying intellectual property

38. A further issue that should be addressed relates to security rights in tangible property embodying intellectual property rights (e.g. pharmaceuticals and mechanical devices that reflect patented inventions; DVDs, paperback books and lithographs that embody copyrighted work; and labels, apparel and merchandise containing trademarks). While the security right in such tangible property would be worthless if it did not give rights of use of the embodied intellectual property, the security right in the tangible property is limited by the rights of the holder of rights in the embodied intellectual property. For example, a person that buys a copy of a DVD containing copyrighted music cannot then make and sell thousands of duplicates without permission of the intellectual property owner.

39. Under current practice, intellectual property law addresses this situation under the “exhaustion” doctrine. Under this rule, an authorized sale of a copy exhausts some rights, such as the right to control further sales of that particular copy. Thus, if the grantor has obtained ownership of the goods in a transaction that “exhausted” relevant intellectual property rights, a secured creditor could resell the goods at least

within the authorized territory without infringement. However, the treatment of the exhaustion doctrine is a complex issue, especially in international transactions, and would need to be carefully examined (see also para. 72 below).

D. Third-party effectiveness of a security right

1. General approach of the draft guide

40. The main method for making a security right effective against third parties is registration of a notice with limited information in a general security rights registry (see A/CN.9/631, recommendation 33). Other methods for achieving third-party effectiveness of a security right include registration in a specialized registry (see A/CN.9/631, recommendation 43), transfer of possession and control (see A/CN.9/631, recommendation 38, 50 and 51).

2. Possible asset-specific adjustments

(a) Intellectual property that is registrable

41. Registration of a notice in the general security rights registry is relevant with respect to the third-party effectiveness of a security right in intellectual property. Similarly, registration of a security right in a specialized registry is relevant under the law of many jurisdictions (the draft guide simply recognizes it if it exists, but does not require it), at least with respect to certain types of intellectual property, such as patents and trademarks (and, in some States, copyrights). Other methods for achieving third-party effectiveness of a security right, such as transfer of possession or control, are not relevant for intellectual property (see A/CN.9/631, recommendations 38 and 50).

42. Coordination between the general security rights registry and any specialized registry, such as a patent or trademark registry, is an issue that would need to be addressed, in particular since:

(a) Intellectual property registries may be indexed by asset while the security rights registry is indexed by the name of the grantor of the security right;

(b) Intellectual property registries may involve document registration rather than notice registration and the legal effects may be the creation of a right (title, right to use or security right), rather than only the third-party effectiveness of a security right as is the case with the general security rights registry;

(c) Intellectual property registries may involve the registration of title, right to use and security right in an intellectual property asset rather than only to a security right as is the case with the general security rights registry;

(d) Registration of a security right in after-acquired property may not be possible in an intellectual property registry, while it is possible in the general security rights registry; and

(e) Multiple registrations in the various registries would increase cost and effort both for registrations and searches (under the draft guide, the secured creditor may choose to register in the general security rights registry or in the specialized registry (if registration of security rights is permitted), although registration in the specialized registry provides a higher priority ranking).

(b) Intellectual property that is not registrable

43. Future work would need to address the third-party effectiveness of security rights in intellectual property with respect to which there is no specialized registry (e.g. trade secrets or copyrights in many States). In this situation, a security right in such intellectual property may become effective against third parties automatically upon its creation or upon registration in the general security rights registry. Another approach, which conforms to the practice in a few States, would be to provide that intellectual property not subject to a registration system might not be used as security for credit at all. However, such an approach would not be consistent with the purpose of the draft guide to modernize the law so as to promote increased access to secured credit.

44. Yet another approach would be to provide that, where there is no registry for the specific intellectual property, a security right in intellectual property may become effective against third parties by registration of a notice in the general security rights registry. However, this approach (which is already possible under the general recommendations of the draft guide) would require that the issues identified above (see para. 42) be addressed through new asset-specific recommendations. In particular, the fact that the general security rights registry would not reflect the chain of title in intellectual property as an encumbered asset and secured creditors would have to check the chain of title in the encumbered asset outside the general security rights registry should be carefully considered (of course, this is the case with any other movable property with the exception of receivables with respect to which even outright transfers are registrable). Otherwise, if the grantor transferred title to the intellectual property and subsequently created a security right, the secured creditor would run the risk of not obtaining an effective security right.

E. Registry system

1. General approach of the draft guide

45. The draft guide recommends a general security rights registry (see A/CN.9/631, recommendations 55-73). In general, the purpose of the registry system in the draft guide is to provide a method for making a security right effective in existing or future assets, to establish an efficient point of reference for priority rules based on the time of registration and to provide an objective source of information for third parties dealing with a grantor's assets as to whether the assets may be encumbered by a security right.

46. Under this approach, registration is accomplished by registering a notice as opposed to the security agreement or other document (see A/CN.9/631, recommendation 55, subpara. (b)). The notice need only provide the following information:

- (a) An identification of the grantor and the secured creditor and their addresses;
- (b) A description that reasonably identifies the encumbered assets, with a generic description being sufficient;
- (c) The duration of the effectiveness of the registration; and
- (d) If the enacting State so decides, a statement of the maximum amount secured (see A/CN.9/631, recommendation 58).

47. The draft guide provides precise rules for identifying the grantor, whether an individual or a legal person. This is because notices are indexed and can be retrieved by searchers according to the name of the grantor or according to some other reliable identifier of the grantor (see A/CN.9/631, recommendations 55, subpara. (h), and 59-61). The draft guide contains other rules to simplify operation and use of the registry.

2. Possible asset-specific adjustments

(a) Coordination of registries

48. As discussed above, many States maintain registries for recording transfers, including security rights, with respect to intellectual property. These registries exist in most States for patents and trademarks. Some States have similar registries for copyrights, but the practice is not universal. The registry proposed in the draft guide is a notice-based registry. The idea is that the registry only gives notice of a security right and a reasonable identification of the collateral, usually by generic category. Such a system works well for tangible and certain intangible assets (e.g. receivables).

49. Intellectual property registries, however, primarily use recording act structures or “document registration” systems. In those systems, it is necessary to record the entire instrument of transfer, or, in some cases, a detailed memorandum of transfer. The reason for this is that in many cases the transfer may only involve limited rights in the intellectual property. As such, it is essential for the instrument of transfer to identify the precise right being transferred in order to give effective notice to searchers and to allow efficient utilization of assets. In addition, the intellectual property systems index registrations by the specific item of intellectual property, not by grantor. This is because the central focus is on the intellectual property itself, which may have multiple co-inventors or co-authors and may be subject to multiple changes in ownership as transfers are made.

50. Coordination between the general security rights registry and any specialized intellectual property registry is an issue that would need to be addressed, as mentioned above (see para. 42). In addition, the issue would need to be examined as to whether the general security rights registry proposed in the draft guide should be used for security rights in intellectual property at all, especially in cases where a specialized intellectual property registry is otherwise available.

(b) After-acquired assets

51. An essential feature of the general security rights registry recommended in the draft guide is that it can apply to “after-acquired” property of the grantor. This means that the security right can cover assets to be later acquired by the grantor (see A/CN.9/631, recommendation 16). The notice may also cover assets identified by generic description (see A/CN.9/631, recommendation 64). Thus, if the security right covers all existing or later acquired inventory the notice may so identify such inventory. Since priority is determined by date of registration, the lender may maintain its priority position in later acquired inventory. This greatly facilitates revolving credit facilities, since a lender extending new credit under such a facility knows that it can maintain its priority position in new assets that are included in the borrowing base.

52. Existing intellectual property registries, however, do not readily accommodate after-acquired property. Since transfers of or security rights in intellectual property are indexed against each specific item of intellectual property, they can only be effectively recorded after the intellectual property is first registered in the registry. This means that a blanket recording in a specialized registry with respect to “after-acquired” intellectual property would not be effective, but instead a new recording is required each time a new item of intellectual property is acquired.

53. At the Colloquium on Security Interests in Intellectual Property Rights, intellectual property professionals indicated that they had undertaken some considerable work on this issue under the auspices of WIPO. The Commission may profitably examine that work in addressing this matter.

(c) Dual registration

54. The draft guide permits registration with respect to a security right in intellectual property through registration in either the general security rights registry or a specialized intellectual property registry, or in both of them. The utility of each of these approaches should be the subject of further study in light of the benefits that can be obtained as against the costs involved for multiple filing and searching.

F. Priority of a security right

1. General approach of the draft guide

55. The priority of a security right is based on the time of registration (i.e. before creation) or the time a security right was made effective against third parties (i.e. after creation; see A/CN.9/631, recommendation 78). However, a security right that was made effective against third parties by registration in a specialized registry (that provides for registration of security rights) is superior to a security right that was made effective against third parties by registration of a notice in the general security rights registry (see A/CN.9/631, recommendation 83). Similarly, a security right made effective by transfer of possession or control is superior to a security right made effective by registration of a notice in the general security rights registry (see A/CN.9/631, recommendations 99 and 101). Finally, with limited exceptions, transferees of encumbered assets take the assets subject to any security right that was effective against third parties at the time of the transfer (see A/CN.9/631, recommendations 85-88).

2. Possible asset-specific adjustments

(a) Identification of competing claimants

56. Where the encumbered asset is intellectual property, future work should discuss the types of competing claimant (for the definition of “competing claimant”, see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation). Competing claimants may differ depending on whether a transfer of intellectual property, an exclusive or non-exclusive licence or a security right in intellectual property is involved.

57. In the case of a transfer or an exclusive licence of intellectual property that is not subject to registration, the main competing claimants are transferees and the basic rule is that the first transfer in time prevails. With respect to intellectual property that may be registered, the main rule is that the first transferee to register

in the intellectual property registry has priority. In some jurisdictions, a later-in-time transferee that obtained its right in good faith (i.e. without notice of the prior transfer) may have priority. In the case of a non-exclusive licence, the primary competing claimants would be the licensor, competing title claimants and the creditors of the non-exclusive licensee. This is because the creditors of the non-exclusive licensee may not have the right to stop competing claimants from using the intellectual property and need the cooperation of the licensor.

(b) Relevance of knowledge of prior transfers or security rights

58. The rule providing that knowledge of the existence of a right on the part of a competing claimant is irrelevant for determining priority may need to be reconsidered with respect to security rights in intellectual property (see A/CN.9/631, recommendation 75). As mentioned, many intellectual property registries provide that a later conflicting transfer may only gain priority if it is recorded first and taken without knowledge of a prior conflicting transfer. This rule applies both to security rights and to title transfers recorded in the registry. Inconsistencies could result if the knowledge requirement for security rights was treated differently than title transfers. This matter requires further study.

(c) Priority of a right registered in an intellectual property registry

59. The rule that registration in a specialized registry (including an intellectual property registry) provides a right with higher priority status than a right registered in the general security rights registry is also appropriate with respect to security rights in intellectual property (see A/CN.9/631, recommendation 83). In this regard, it is worth reviewing how the operation of intellectual property registries differs from that for the general security rights register proposed in the draft guide (see para. 42 above).

(d) Priority of a right that is not registrable in an intellectual property registry

60. Another issue is the priority rule with respect to security rights in intellectual property with respect to which there is no specialized intellectual property registry. One approach may be to provide that, in such cases, priority for security rights is determined by the order of registration in the general security rights registry recommended in the draft guide. However, as discussed above, transfers of title in intellectual property are not registrable in the general security rights registry. Thus, unless such title transfers are registrable in the general security rights registry, as between a prior title transfer and a registered security right, the prior title transfer would evidently prevail. This means a creditor would still need to search outside the registry to find prior title transfers, as is the case with movable property in general.

(e) Rights of transferees of encumbered intellectual property

61. The rules of the draft guide are sufficient for the situation where the security right is created and made effective against third parties and thereafter title to the intellectual property is transferred. The basic rule would be that the transferee takes the intellectual property subject to the security right (see A/CN.9/631, recommendation 85). The first exception to the rule would be applicable in the case where the asset sold or licensed is intellectual property. The buyer or licensee would take the intellectual property free of the security right if the secured creditor authorizes the grantor to sell or license the encumbered intellectual property

(see A/CN.9/631, recommendation 86). However, there is some doubt in intellectual property circles as to whether the second exception should also apply, that is whether a non-exclusive licensee in the ordinary course of business (that complies with the terms of the licence and appropriate instructions to pay any secured creditor of the licensor that has a security right in any royalties owed by the licensee to the licensor) should take free of a security right created by the licensor (see A/CN.9/631, recommendation 87, subpara. (c); see also paras. 62 and 63 below).

(f) Rights of licensees of encumbered intellectual property

62. Intellectual property is routinely licensed. The retained rights of a licensor, such as the right to receive royalties, and the rights of a licensee can both be used as an encumbered asset for credit. In each case, it is necessary to consider the relevant priority rules where the competing claimants are the lenders of the licensor and the licensee, or the licensor and the lenders of the licensee. Generally, there should not be a competition between the lender of the licensor and the lender of the licensee because each would have a different encumbered asset. The lender of the licensor would normally have a security right in royalties owed by the licensee to the licensor, while the lender of the licensee would have a security right in royalties owed by a sub-licensee to the licensee. In any case, the lender of the licensee would not have rights any greater than the licensee itself, so that if the licensee defaulted under the licence, the licensor could terminate the licence, if the licence so provided.

63. With regard to the first case, the licensor's lender would need to know that in case of enforcement the licensee would continue to render performance and pay royalties to the lender, while a licensee would need to know that so long as it continued performance its licence would not be terminated. As to the second case, the licensor would need to know that it had mechanisms to gain priority over the licensee's lender and other creditors with respect to royalties payable under the licence. In addressing those issues, it would be appropriate to preserve party autonomy so that the parties could adjust their respective rights and obligations by individual agreement. The provisions of the draft guide regarding party autonomy, in particular with respect to priority, are relevant in that regard and may need to be adjusted or supplemented by appropriate commentary (see A/CN.9/631, recommendations 8 and 77).

(g) Rights of "ordinary course" non-exclusive licensees

64. One question of particular importance is whether a non-exclusive licensee "in the ordinary course of business" of the licensor should take free of any security rights created by the licensor (i.e. whether recommendation 87, subpara. (c), should apply in the context of security rights in intellectual property). The concept of an "ordinary course" transaction comes from the practices in tangible property. No customer would buy goods from a dealer if the customer thought that a lender could repossess the goods because the dealer did not pay its loan. Thus, to facilitate commercial practices, the draft guide allows an "ordinary course" buyer to take free of the prior security right. However, under the draft guide, the security right continues in proceeds from the sale (see A/CN.9/631, recommendations 18, 40 and 41). Thus, the lender loses a security right in the goods to an ordinary course buyer, but in exchange obtains a security right in proceeds from their sale or disposition.

65. It is argued that this “ordinary course of business” concept is inappropriate for intellectual property. Under the *nemo dat* principle, a licensee of intellectual property only takes the actual right transferred subject to all prior transfers, including security rights. Thus, according to this view, application of an “ordinary course of business” exception would be incompatible with this principle and the ability of owners-licensors to control use of their intellectual property. Moreover, if a sub-licensee can “take free” of a prior security right, it could limit the ability of lenders to police improvident sub-licences (to determine whether they were in fact made in the ordinary course of business of the licensee). This is a matter that needs further study.

G. Rights and obligations of third-party obligors

1. General approach of the draft guide

66. The draft guide discusses the rights and obligations of debtors other than the debtor granting a security right in an asset to secure the payment or other performance of an obligation. Such third-party debtors (obligors is the term used in the draft guide to distinguish from the debtor-grantor) include the debtor of an assigned receivable, the person obligated under a negotiable instrument, the guarantor/issuer, confirmer, or nominated person where the encumbered asset is in the form of proceeds under an independent undertaking (for the definition of “proceeds under an independent undertaking”, see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation), the depositary bank where the encumbered asset is the right to payment of funds credited to a bank account (for the definition of “right to payment of funds credited to a bank account”, see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation) and the issuer of a negotiable document.

2. Possible asset-specific adjustments

67. Any future work on security rights in intellectual property would need to include a discussion of the rights and obligations of third parties such as the licensor in a situation where the licensee has created a security right in its licence. In the same way that a depositary bank is protected in cases where the encumbered asset is the right to payment of funds credited to a bank account, the rights of a licensor may need to be protected. For example, a licensor may help facilitate the financing of a licensee’s interest by agreeing with the lender to enforce various licence clauses in case the licensee defaults on the loan, such as withholding performance or terminating the licence. In these situations, licensors need to be able to preserve the integrity of their intellectual property and contractual relationships.

H. Enforcement of a security right

1. General approach of the draft guide

68. Under the draft guide, after default the secured creditor is entitled (see A/CN.9/631, recommendation 134):

- (a) To obtain possession of a tangible encumbered asset;
- (b) To sell or otherwise dispose of, lease or license an encumbered asset;

(c) To propose to the grantor that the secured creditor accept an encumbered asset in total or partial satisfaction of the secured obligation;

(d) To collect on or otherwise enforce a security right in an encumbered asset that is a receivable, negotiable instrument, right to payment of funds credited to a bank account or proceeds under an independent undertaking;

(e) To enforce rights under a negotiable document;

(f) To enforce its security right in an attachment to immovable property; and

(g) To exercise any other right provided in the security agreement (except to the extent inconsistent with the provisions of the law recommended in the draft guide) or any other law.

69. In exercising its rights, the secured creditor has to act in good faith and in a commercially reasonable manner (see A/CN.9/631, recommendation 128). In particular with respect to extrajudicial enforcement, the secured creditor must abide by this standard of conduct and exercise its remedies subject to certain notifications and additional safeguards (see A/CN.9/631, recommendations 141-144).

2. Possible asset-specific adjustments

70. The enforcement of a security right in intellectual property raises special issues that would need to be addressed. For example, the right of the secured creditor to take possession of the encumbered asset is not relevant if the encumbered asset is intellectual property (see A/CN.9/631, recommendations 142 and 143). The question arises here (as with all types of intellectual property) as to whether an equivalent right of the secured creditor to take control should be introduced and how this would fit with the particular type of intellectual property involved.

71. Another question that would need to be discussed relates to the right of the secured creditor to dispose of, license, accept or collect licence fees with respect to intellectual property, in particular in cases where the intellectual property is inseparable from another asset (e.g. trademarked goods or goods with embedded software; see paras. 38 and 39 above) or in situations where the intellectual property has been licensed and the rights of the licensor must be taken into account. A further question relates to responsibilities of a secured creditor that becomes the owner of a trademark or other intellectual property right to renew and maintain the trademark in good order, or to police its use against infringement.

72. A further question arises with respect to encumbered assets that consist of goods that embody intellectual property. The main issue is the extent to which a security right that only applies to the goods allows the secured creditor to deal in or otherwise dispose of the goods consistent with the intellectual property right, taking into account any doctrine of intellectual property law that would permit a transfer of the goods with the intellectual property embodied in the goods (see paras. 38 and 39 above).

73. All those issues would need to be addressed also for situations where the encumbered asset is not intellectual property but the rights of a licensee arising from a licence to use intellectual property. In such a situation, the rights of the secured creditor may be constrained. For example, if the licensee-grantor has created a lower-ranking security right in the same licence, usually enforcement of a higher-ranking security right would eliminate a lower-ranking security right

(see A/CN.9/631, recommendations 158 and 159). However, where the encumbered asset is merely a licence, the secured creditor only succeeds to the licensee's rights. A mere licensee cannot enforce the intellectual property right against another mere licensee or secured creditor with a lower-ranking security right. Only the licensor (or appropriate right-holder) can do that (in some jurisdictions, exclusive licensees may join the licensor as a party to the proceedings). Thus, a secured creditor enforcing its security right against a licensee may have limited rights against other parties. This issue deserves further study, especially in reference to a determination of the "competing claimants" to a security right in intellectual property licences.

I. Insolvency

1. General approach of the draft guide

74. In the case of insolvency of the grantor, the effectiveness of a security right is preserved subject to any avoidance actions and stays (see A/CN.9/631, recommendations of the *UNCITRAL Legislative Guide on Insolvency Law*¹⁰ (hereinafter the "*UNCITRAL Insolvency Guide*"), chap. XI, recommendations (35), (39) and (46)). The priority of a security right is also preserved subject to any preferential claims (see A/CN.9/631, recommendations 178-180). Post-commencement finance does not take priority over pre-commencement security rights, but the insolvency court may authorize the post-commencement creation of security rights with priority over pre-commencement security rights in certain situations (see A/CN.9/631, recommendations of the *UNCITRAL Insolvency Guide* (66) and (67)). Secured creditors are entitled to participate in insolvency proceedings and to vote on a reorganization plan, which may be binding on secured creditors even without their approval if certain conditions are met (see A/CN.9/631, recommendations of the *UNCITRAL Insolvency Guide* (126), (151) and (152)).

2. Possible asset-specific adjustments

75. The provisions of the draft guide with respect to the general application of insolvency law, in particular with respect to stays and similar limitations, would apply to security rights in intellectual property (see A/CN.9/631, recommendations of the *UNCITRAL Insolvency Guide* (35), (39), (46) and (49)).

76. However, certain special issues would need to be addressed. One example is the effect of the rejection of a licence in cases in which the insolvent debtor is the licensor. In such a situation, a licensee may have invested considerable sums in further developing or commercializing the intellectual property, so that rejection of the licence may entail significant financial loss. On the other hand, insolvent licensors need some protection against a continuing obligation to support overly burdensome licences (for the treatment of contracts in the *UNCITRAL Insolvency Guide*, see part two, chap. II, sect. E).

77. Another example is the treatment of intellectual property as a third-party-owned asset in cases in which the insolvent debtor is the licensee. In this situation, there is a question as to whether the licensee's interest under the licence should become part of the insolvency estate where other law, such as intellectual property law, restricts the assignment of such a licence without the licensor's consent. In cases where the interest of a licensee does become part of the insolvency estate, issues arise regarding the obligation of the insolvency estate to perform ongoing

¹⁰ United Nations publication, Sales No. E.05.V.10.

obligations, such as payment of royalties, and the ability of the insolvency representative to dispose of the licence consistent with its terms. It should also be noted that there is considerable difference in the treatment of these issues in the insolvency laws of different countries, which will necessitate a careful study in order to achieve a harmonized approach.

J. Acquisition financing

1. General approach of the draft guide

78. The draft guide discusses acquisition financing with respect to tangible property. It provides for a unitary approach to acquisition financing, in the context of which all rights securing the payment of the purchase price for tangible property fall under a unitary notion of a security right with the result that, with the exception of certain special provisions for acquisition security rights, the provisions applicable to security rights apply to acquisition security rights (for the definition of “acquisition security right”, see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation). As an alternative, the draft guide provides for a non-unitary approach to acquisition financing, in the context of which the terminology of various types of rights securing the purchase price of tangible property is maintained, while certain special provisions are introduced to ensure that acquisition financing rights (for the definition of “acquisition financing right”, see A/CN.9/631, Introduction, sect. B, Terminology and rules of interpretation) are treated as functional equivalents of acquisition security rights.

2. Possible asset-specific adjustments

79. The provisions of the draft guide with respect to acquisition financing apply only to tangible property. One of the results of this approach is that standard intellectual property licences, in the context of which the licensor by definition reserves title and assignments of intellectual property with a right to terminate are not assimilated to security rights. This result is generally accepted as being appropriate. However, an inadvertent result of this approach is that the draft guide does not discuss acquisition financing with respect to intellectual property. In view of the importance of this type of financing, the draft guide should address it.

80. An example may illustrate the issue. A grantor grants a lender a security right in all its existing and future intellectual property. The lender registers a notice of its security in the general security rights register. A licensor then grants the grantor a licence of intellectual property. The licensor would like a mechanism to gain priority over the lender’s pre-existing security right, for example to secure a right to receive royalties. Under the priority rules in the draft guide, since priority is mainly determined on the basis of order of registration, the licensor has no mechanism to do so without an acquisition security right. Thus, in order to provide parity between sellers of goods and licensors of intellectual property, an acquisition financing right would seem appropriate. On the other hand, if priority is determined by the rules of a specialized intellectual property registry, an acquisition financing right is unnecessary (at least in legal systems in which such a specialized registry exists and, in any case, only with respect to intellectual property rights that may be registered in such a registry). This is because the lender cannot gain priority unless it makes a new registration identifying the specific intellectual property, and the licensor can always record the licence as soon as it is made and before the lender

can file. It will be necessary to study in what situations an acquisition financing right is appropriate for intellectual property.

K. Law applicable to a security right in intellectual property

1. General approach of the draft guide

81. Under the draft guide, the creation, third-party effectiveness, priority and enforcement of a security right in intangible property is subject to the law of the State in which the grantor is located (see A/CN.9/631, recommendation 204). The grantor is located in the State in which it has its place of business. In the case of places of business in more than one State, reference is made to the State in which the grantor has its central administration (see A/CN.9/631, recommendation 207).

82. The mutual rights and obligations of the grantor and the secured creditor with respect to the security right are governed by the law chosen by them and, in the absence of a choice of law, by the law governing the security agreement (see A/CN.9/631, recommendation 212).

2. Possible asset-specific adjustments

83. A new asset-specific recommendation may need to be introduced with respect to the law applicable to the creation, third-party effectiveness, priority and enforcement of a security right in intellectual property. Intellectual property conventions adopt the principle of territoriality. The consequence is that all issues concerning security rights in intellectual property are referred to the law of the place where the secured creditor exercises its security right (*lex protectionis*).

84. In addition, under the principle of minimum rights, all States parties to those conventions accord a basic level of protection to intellectual property owners and their successors. Finally, under the principle of national treatment, each State has to treat nationals of another State no less favourably than it treats its own nationals. This creates a system in which nationals of any State know that in any other State they will be accorded at least certain minimum rights, along with any greater rights that are accorded to locals. The benefits of this structure, including ease of administration and fairness in application, have been proven by experience.

85. Other possible approaches are based on the principle of “material reciprocity” or “country of origin”, in which the rights of a person in the home or “origin” State determines the extent of a person’s rights in another State. A further approach could be to provide that the third-party effectiveness and priority of a security right in intellectual property is governed by the law of the grantor’s location, with the exception of a priority contest between a secured creditor and a transferee under an outright transfer of an intellectual property right, which would be governed by the law of the State in which the intellectual property right is used or protected.

86. From the point of view of lenders, it would be more efficient to look to a single national law, as recommended in the draft guide (i.e. the law of the location of the grantor), to determine issues of creation, third-party effectiveness, priority and enforcement of a security right regardless of the State where these issues arise. However, from the point of view of intellectual property owners, these issues with respect to a security right also entail issues regarding ownership and enforcement of the right, especially in the context of minimum rights and national treatment, issues

that are determined under the territoriality principle. Thus, further work is needed on the appropriate law for security rights in intellectual property.

IV. Conclusions

87. The draft guide contains a general part and an asset-specific part, since not all States may need all asset-specific parts of the draft guide. The general part of the draft guide applies to security rights in intellectual property. However, the asset-specific part of the draft guide does not contain provisions (commentary or recommendations) dealing with security rights in intellectual property. For this reason, the draft guide defers to intellectual property law with respect to any inconsistency between its general part and intellectual property law. In addition, the draft guide draws the attention of States to the need to consider adjusting their laws to avoid any such inconsistencies without, however, providing any specific guidance in that regard.

88. The Commission may wish to consider that such guidance may be usefully provided in an asset-specific appendix of the draft guide, in view of the generally recognized importance of intellectual property as security for credit and the detrimental effects that may flow from an inadequate coordination between secured transactions and intellectual property laws. In addition, the Commission may wish to consider that such work would be feasible to the extent it would involve asset-specific commentary and recommendations such as those mentioned above. As indicated by the Colloquium on Security Interests in Intellectual Property Rights, an important element ensuring the feasibility of this work would be the participation of representatives of international organizations with expertise in the area of intellectual property, such as WIPO, international associations of intellectual property practitioners, together with international organizations and international associations of secured financing experts, in a balanced way that would adequately reflect the various practices and the various legal systems of the world.

89. The Commission may wish to entrust to Working Group VI the preparation of an asset-specific text on security rights in intellectual property that would usefully supplement the work of the Commission on the draft guide by providing specific guidance with respect to security rights in intellectual property. The Commission may also wish to consider inviting international organizations with expertise in the area of intellectual property, such as WIPO, and international associations of intellectual property and secured financing practitioners, to participate actively in this work.

B. Note by the Secretariat on possible future work in the area of electronic commerce

(A/CN.9/630 and Add.1-5) [Original: English]

Comprehensive reference document on elements required to establish a favourable legal framework for electronic commerce: sample chapter on international use of electronic authentication and signature methods

1. In 2004, having completed its work on the Convention on the Use of Electronic Communications in International Contracts, Working Group IV (Electronic Commerce) of the United Nations Commission on International Trade Law (UNCITRAL) requested the Secretariat to continue monitoring various issues related to electronic commerce, including issues related to cross-border recognition of electronic signatures, and to publish the results of its research with a view to making recommendations to the Commission as to whether future work in those areas would be possible (see A/CN.9/571, para. 12).

2. In 2005, the Commission took note of the work undertaken by other organizations in various areas related to electronic commerce and requested the Secretariat to prepare a more detailed study, which should include proposals as to the form and nature of a comprehensive reference document discussing the various elements required to establish a favourable legal framework for electronic commerce, which the Commission might in the future consider preparing with a view to assisting legislators and policymakers around the world.¹ In 2006, UNCITRAL considered a note prepared by its secretariat pursuant to that request (A/CN.9/604). The note identified the following areas as possible components of a comprehensive reference document: (a) authentication and cross-border recognition of electronic signatures; (b) liability and standards of conduct for information-services providers; (c) electronic invoicing and legal issues related to supply chains in electronic commerce; (d) transfer of rights in tangible goods and other rights through electronic communications; (e) unfair competition and deceptive trade practices in electronic commerce; and (f) privacy and data protection in electronic commerce. The note also identified other issues that, although in a more summary fashion, could be included in such a document: (a) protection of intellectual property rights; (b) unsolicited electronic communications (spam); and (c) cybercrime.

3. There was support for the view that the task of legislators and policymakers, in particular in developing countries, might be greatly facilitated if the Commission were to formulate a comprehensive reference document dealing with the topics identified by the Secretariat. Such a document, it was also said, might also assist the Commission to identify areas in which it might itself undertake future harmonization work. However, there were also concerns that the range of issues identified was too wide and that the scope of the comprehensive reference document might need to be reduced. The Commission eventually agreed to ask its secretariat to prepare a sample portion of the comprehensive reference document dealing

¹ *Official Records of the General Assembly, Sixtieth Session, Supplement No. 17 (A/60/17)*, para. 214.

specifically with issues related to authentication and cross-border recognition of electronic signatures, for review at its fortieth session, in 2007.²

4. The annex to the present note contains the introductory part of a sample chapter dealing with legal issues related to the international use of electronic authentication and signature methods (henceforth referred to as the “sample chapter”). The addenda to the present note discuss the legal treatment of electronic authentication and signatures and legal problems arising out of their international use.

5. The Commission may wish to consider the structure, level of detail, nature of discussion and type of advice provided in the sample chapter and consider whether it would be desirable and useful for the Secretariat to prepare other chapters following the same model, to deal with other issues that the Commission may wish to select from among those proposed earlier (see para. 2 above). Alternatively, the Commission may wish to request that the Secretariat continue to follow closely legal developments in the relevant areas, with a view to making appropriate suggestions in due course. In that case, the Commission may wish to consider whether the Secretariat should be requested to publish the sample chapter, with whatever amendments the Commission may consider appropriate, as a stand-alone publication.

² Ibid., *Sixty-first Session, Supplement No. 17* (A/61/17), para. 216.

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Foreword

The present document analyses the main legal issues arising out of the use of electronic signatures and authentication methods in international transactions. Part one provides an overview of methods used for electronic signature and authentication and their legal treatment in various jurisdictions (see below, paras. [...]–[...]).* Part two considers the use of electronic signature and authentication methods in international transactions and identifies the main legal issues related to cross-border recognition of electronic signature and authentication methods (see below, paras. [...]–[...]).

It has been observed that, from an international perspective, legal difficulties are more likely to arise in connection with the cross-border use of electronic signature and authentication methods that require the involvement of third parties in the signature or authentication process. This is the case, for instance, of electronic signature and authentication methods supported by certificates issued by a trusted third-party certification services provider, in particular digital signatures under a public key infrastructure (PKI). For this reason, part two of this document pays special attention to international use of digital signatures under a PKI. This emphasis should not be understood as a preference or endorsement of this or any other particular type of authentication method or technology.

Introduction

1. Information and computer technology have developed various means for linking information in electronic form to particular persons or entities, for ensuring the integrity of such information or for enabling persons to demonstrate their entitlement or authorization to obtain access to a certain service or repository of information. These functions are sometimes referred to generically either as electronic “authentication” or electronic “signature” methods. Sometimes, however, distinctions are made between electronic “authentication” and electronic “signature”. The use of terminology is not only inconsistent, but to some extent misleading. In a paper-based environment, the words “authentication” and “signature” and the related actions of “authenticating” and “signing” do not have exactly the same connotation in different legal systems and have functionalities that may not necessarily correspond to the purpose and function of the so-called electronic “authentication” and “signature” methods. Furthermore, the word “authentication” is sometimes generically used in connection with any assurance of both authorship and integrity of information, but some legal systems may distinguish between those elements. A short overview of differences in terminology and legal understanding is therefore necessary with a view to establishing the scope of the present document.

2. Under common law on civil evidence, a record or document is regarded as “authentic” if there is evidence that the document or record “is what its proponent

* All cross references in this document and its addenda, as well as all cross references in their footnotes, will be finalized when the final document is issued in consolidated form.

claims”.¹ The notion of “document” as such is fairly broad and generally encompasses “anything in which information of any description is recorded”.² This would include, for example, such things as photographs of tombstones and houses,³ account books⁴ and drawings and plans.⁵ The relevancy of a document as a piece of evidence is established by connecting it with a person, place or thing, a process which in some common law jurisdictions is known as “authentication”.⁶ Signing a document is a common — albeit not exclusive — means of “authentication”, and, depending on the context, the terms “to sign” and “to authenticate” may be used as synonyms.⁷

3. A “signature”, in turn, is “any name or symbol used by a party with the intention of constituting it his signature”.⁸ It is understood that the purpose of statutes that require a particular document to be signed by a particular person is to confirm the genuineness of the document.⁹ The paradigm case of signature is the signatory’s name, written in the signatory’s own hand, on a paper document (a “handwritten” or “manuscript” signature).¹⁰ However, the handwritten signature is not the only conceivable type of signature. Since courts regard signatures as “only a mark”, unless the statute in question requires the signature to be an autograph, “the printed name of the party who is required to sign the document is enough”, or the signature “may be impressed upon the document by a stamp engraved with a facsimile of the ordinary signature of the person signing”, provided that proof in these cases is given “that the name printed on the stamp was affixed by the person signing”, or that such signature “has been recognized and brought home to him as having been done by his authority so as to appropriate it to the particular instrument”.¹¹

¹ United States of America, Federal Rules of Evidence, rule 901, subdivision (a): “The requirement of authentication or identification as a condition precedent to admissibility is satisfied by evidence sufficient to support a finding that the matter in question is what its proponent claims.”

² United Kingdom of Great Britain and Northern Ireland, Civil Evidence Act 1995, chapter 38, section 13.

³ *Lyell v. Kennedy* (No. 3) (1884) 27 Ch.D. 1 (United Kingdom, Chancery Division).

⁴ *Hayes v. Brown* [1920] 1 K.B. 250 (United Kingdom, Law Reports, King’s Bench).

⁵ *J. H. Tucker & Co., Ltd. v. Board of Trade* [1955] 2 All ER 522 (United Kingdom, All England Law Reports).

⁶ *Farm Credit Bank of St. Paul v. William G. Huether*, 12 April 1990 (454 N.W.2d 710, 713) (United States, Supreme Court of North Dakota, North Western Reporter).

⁷ In the context of the revised article 9 of the United States Uniform Commercial Code, for example, “authenticate” is defined as “(A) to sign; or (B) to execute or otherwise adopt a symbol, or encrypt or similarly process a record in whole or in part, with the present intent of the authenticating person to identify the person and adopt or accept a record.”

⁸ *Alfred E. Weber v. Dante De Cecco*, 14 October 1948 (1 N.J. Super. 353, 358) (United States, New Jersey Superior Court Reports).

⁹ *Lobb v. Stanley* (1844), 5 Q.B. 574, 114 E.R. 1366 (United Kingdom, Law Reports, Queen’s Bench).

¹⁰ Lord Denning in *Goodman v. Eban* [1954] Q.B.D. 550 at 56: “In modern English usage when a document is required to be signed by someone that means that he must write his name with his own hand upon it.” (United Kingdom, Queen’s Bench Division).

¹¹ *R. v. Moore: ex parte Myers* (1884) 10 V.L.R. 322 at 324 (United Kingdom, Victorian Law Reports).

4. Legal signature requirements as a condition for the validity of certain acts in common law jurisdictions are typically found in the British Statute of Frauds¹² and its versions in other countries.¹³ With time, courts have tended to interpret the Statute of Frauds liberally, out of recognition that its strict form requirements were conceived against a particular background¹⁴ and that strict adherence to its rules might unnecessarily deprive contracts of legal effect.¹⁵ Thus, in the last 150 years, common law jurisdictions have seen an evolution of the concept of “signature” from an original emphasis on form to a focus on function.¹⁶ Variations on this theme have been considered by the English courts from time to time, ranging from simple modifications such as crosses¹⁷ or initials,¹⁸ through pseudonyms¹⁹ and identifying phrases,²⁰ to printed names,²¹ signatures by third parties²² and rubber stamps.²³ In all

¹² The Statute of Frauds was originally passed in Great Britain in 1677 “[f]or the prevention of many fraudulent practices which are commonly endeavoured to be upheld by perjury and subordination of perjury.” Most of its provisions were repealed in the United Kingdom during the twentieth century.

¹³ For example, section 2-201, subsection 1, of the Uniform Commercial Code of the United States, which has expressed the Statute of Frauds as follows: “Except as otherwise provided in this section, a contract for the sale of goods for a price of \$500 or more is not enforceable by way of action or defence unless there is some writing sufficient to indicate that a contract for sale has been made between the parties and signed by a party against whom enforcement is sought or by his authorized agent or broker.”

¹⁴ “The Statute of Frauds was passed at a period when the legislature was somewhat inclined to provide that cases should be decided according to fixed rules rather than to leave it to the jury to consider the effect of the evidence in each case. This, no doubt, arose to a certain extent from the fact that in those days the plaintiff and the defendant were not competent witnesses.” (J. Roxborough in *Leeman v. Stocks* [1951] 1 Ch 941 at 947-8) (United Kingdom, Law Reports, Chancery Division) citing approval for the views of J. Cave in *Evans v. Hoare* [1892] 1 QB 593 at 597) (United Kingdom, Law Reports, Queen’s Bench).

¹⁵ As explained by Lord Bingham of Cornhill “It quickly became evident that if the seventeenth century solution addressed one mischief it was capable of giving rise to another: that a party, making and acting on what was thought to be a binding oral agreement, would find his commercial expectations defeated when the time for enforcement came and the other party successfully relied on the lack of a written memorandum or note of the agreement.” (*Actionstrength Limited v. International Glass Engineering*, 3 April 2003, [2003] UKHL 17) (United Kingdom, House of Lords).

¹⁶ Chris Reed, “What is a signature?”, *Journal of Information, Law and Technology*, vol. 3, 2000, and reference to case law therein, available at www2.warwick.ac.uk/fac/soc/law/elj/jilt/2000_3/reed/, accessed on 7 February 2007.

¹⁷ *Baker v. Dening* (1838) 8 A. & E. 94 (United Kingdom, Adolphus and Ellis’ Queen’s Bench Reports).

¹⁸ *Hill v. Hill* [1947] Ch 231 (United Kingdom, Chancery Division).

¹⁹ *Redding, in re* (1850) 14 Jur. 1052, 2 Rob.Ecc. 339 (United Kingdom, Jurist Reports and Robertson’s Ecclesiastical Reports).

²⁰ *Cook, In the Estate of (Deceased) Murison v. Cook and Another* [1960] 1 All ER 689 (United Kingdom, All England Law Reports).

²¹ *Brydges v. Dicks* (1891) 7 T.L.R. 215 (cited in *Brennan v. Kinjella Pty Ltd.*, Supreme Court of New South Wales, 24 June 1993, 1993 NSW LEXIS 7543, 10). Typewriting has also been considered in *Newborne v. Sensolid (Great Britain), Ltd.* [1954] 1 QB 45 (United Kingdom, Law Reports, Queen’s Bench).

²² *France v. Dutton*, 24 April 1891 [1891] 2 QB 208 (United Kingdom, Law Reports, Queen’s Bench).

²³ *Goodman v. J. Eban Ltd.*, [1954] 1 QB 550, cited in *Lazarus Estates, Ltd. v. Beasley*, Court of Appeal, 24 January 1956 ([1956] 1 QB 702); *London County Council v. Vitamins, Ltd.*, *London County Council v. Agricultural Food Products, Ltd.*, Court of Appeal, 31 March 1955 [1955] 2 QB 218 (United Kingdom, Law Reports, Queen’s Bench).

these cases the courts have been able to resolve the question as to whether a valid signature was made by drawing an analogy with a manuscript signature. Thus, it could be said that against a background of some rigid general form requirements, courts in common law jurisdictions have tended to develop a broad understanding of what the notions of “authentication” and “signature” mean, focusing on the intention of the parties, rather than on the form of their acts.

5. The approach to “authentication” and “signature” in civil law jurisdictions is not in all respects identical to the common law approach. Most civil law jurisdictions follow the rule of freedom of form for contractual engagements in private law matters, either expressly²⁴ or impliedly²⁵ subject, however, to a more or less extensive catalogue of exceptions depending on the jurisdiction concerned. This means that, as a general rule, contracts need not be in “writing” or “signed” in order to be valid and enforceable. However, there are civil law jurisdictions that generally require a writing to prove the contents of contracts, except in commercial matters.²⁶ In contrast to common law jurisdictions, civil law countries tend to interpret evidentiary rules rather strictly. Typically, rules on civil evidence establish a hierarchy of evidence for proving the content of civil and commercial contracts. Highest in such ranking are documents issued by public authorities, followed by authentic private documents. Often, such hierarchy is conceived in such a way that the notions of “document” and “signature”, although formally distinct, may become nearly inseparable.²⁷ Other civil law jurisdictions, however, positively link the notion of “document” to the existence of a “signature”.²⁸ This does not mean that a

²⁴ This is recognized, for instance, in article 11, paragraph 1, of the Code of Obligations of Switzerland. Similarly, section 215 of the Civil Code of Germany provides that agreements are only invalid where they failed to observe a form **prescribed** by law or agreed upon by the parties. Except for such specific instances, it is generally understood that private law contracts are not subject to specific form requirements. Where the law expressly prescribes a particular form, that requirement is to be interpreted strictly.

²⁵ In France, for instance, freedom of form is an implication within the basic rules on contract formation under the Civil Code. According to article 1108 of the Civil Code of France, the validity of a contract requires the consent of the promisor, his or her legal capacity, a certain object and a licit cause; once these have been met, the contract is “law between the parties” according to article 1134. This is also the rule in Spain under articles 1258 and 1278 of the Civil Code. Italy also follows the same rule, although less explicitly (see Civil Code of Italy, articles 1326 and 1350).

²⁶ Article 1341 of the Civil Code of France requires a writing for the proof of contracts exceeding a certain value, but article 109 of the Commercial Code admits various types of evidence, without a particular hierarchy. This led the Court of Cassation of France in 1892 to recognize the general principle of freedom of evidence in commercial matters (Cass. civ. 17 mai 1892, DP 1892.1.604; cited in Luc Grynbaum, *Preuve, Répertoire de droit commercial Dalloz*, June 2002, sections 6 and 11).

²⁷ Thus, for instance, under German law a signature is not an essential element of the notion of “document” (*Urkunde*) (Gerhard Lüke and Alfred Walchshöfer, *Münchener Kommentar zur Zivilprozessordnung* (Munich, Beck, 1992), section 415, No. 6. Nevertheless, the hierarchy of documentary evidence established by sections 415, 416 and 419 of the Code of Civil Procedure of Germany clearly links the signature to the document. Indeed, section 416, on the evidentiary value of private documents (*Privaturkunden*), provides that private documents constitute “full proof” for the information they contain as long as they are signed by the author or by a notarized signature). As nothing is provided for documents without a signature, it seems that they share the sort of defective documents (i.e. garbled, damaged), whose evidentiary value is “freely established” by the courts (Code of Civil Procedure of Germany, section 419).

²⁸ Thus, in France, a signature is an “essential element” of private documents (“*actes sous sein privé*”) (see *Recueil Dalloz, Preuve*, no. 638).

document that has not been signed is necessarily deprived of any value as evidence, but such a document would not enjoy any particular presumption and is generally regarded as a “beginning of evidence”.²⁹ “Authentication” is in most civil law jurisdictions a concept that is rather narrowly understood to mean that the authenticity of a document has been verified and certified by a competent public authority or a notary public. In civil procedure it is common to refer instead to the notion of “originality” of documents.

6. As is the case under the common law, the paradigm of a signature in civil law countries is the handwritten one. As regards the signature itself, some jurisdictions tend to admit various equivalents, including mechanical reproductions of signatures, despite a generally formalist approach to evidence.³⁰ Other jurisdictions, however, admit mechanical signatures for commercial transactions,³¹ but until the advent of computer technologies, continued to require a handwritten signature for the proof of other types of contract.³² It could therefore be said that against a general background of freedom of form for the conclusion of business contracts, civil law countries tend to apply strict standards to assess the evidentiary value of private documents and may be dismissive of documents whose authenticity is not immediately recognizable on the basis of a signature.

7. The above discussion shows not only that the notions of signature and authentication are not uniformly understood, but also that the functions they fulfil vary across legal systems. Despite these divergences, a few general common elements can be found. The notions of “authentication” and “authenticity” are generally understood in law to refer to the genuineness of a document or record, that is, that the document is the “original” support of the information it contains, in the form it was recorded and without any alteration. Signatures, in turn, perform three main functions in the paper-based environment: signatures permit to identify the signatory (identification function); signatures provide certainty as to the personal involvement of that person in the act of signing (evidentiary function); and signatures associate the signatory with the content of a document (attribution function).³³ Signatures can be said to perform various other functions as well, depending on the nature of the document that was signed. For example, a signature might attest to the intent of a party to be bound by the content of a signed contract; the intent of a person to endorse authorship of a text (thus displaying awareness of the fact that legal consequences might possibly flow from the act of signing); the intent of a person to associate him or herself with the content of a document written

²⁹ This is the situation in France, for example see *Recueil Dalloz, Preuve*, nos. 657-658.

³⁰ Commentators of the Code of Civil Procedure of Germany point out that requiring a handwritten signature would mean excluding all forms of mechanically made signs, a result that would run counter to ordinary practice and technological progress (see Gerhard Lüke and Alfred Walchshöfer, *Münchener Kommentar zur Zivilprozessordnung* (Munich, Beck, 1992), section 416, No. 5).

³¹ For example, France (see *Recueil Dalloz, Preuve*, no. 662).

³² In France, for instance, the signature could not be replaced with a cross or other signs, by a seal or by fingerprints (see *Recueil Dalloz, Preuve*, no. 665).

³³ *UNCITRAL Model Law on Electronic Signatures with Guide to Enactment 2001* (United Nations publication, Sales No. E.02.V.8), part two, para. 29, available at www.uncitral.org/uncitral/en/uncitral_texts/electronic_commerce.html. This analysis had already served as a basis for functional equivalence criteria in article 7 of the earlier *UNCITRAL Model Law on Electronic Commerce with Guide to Enactment 1996 with Additional Article 5 bis as Adopted in 1998* (United Nations publication, Sales No. E.99.V.4), available at www.uncitral.org/uncitral/en/uncitral_texts/electronic_commerce.html.

by someone else; and the fact that, and the time when, a person has been at a given place.³⁴

8. It should be noted, however, that even though the authenticity is often presumed by the existence of a signature, a signature alone does not “authenticate” a document. The two elements may even be separable, depending on the circumstances. A signature may retain its “authenticity” even though the document to which it is affixed is subsequently altered. Likewise, a document may still be “authentic” even though a signature it contains was forged. Furthermore, the authority to intervene in a transaction and the actual identity of the person in question, while important elements to ensure the authenticity of a document or signature, are neither fully demonstrated by the signature alone, nor sufficient assurance of the authenticity of the documents or of the signature.

9. This observation leads to another aspect of the issue presently discussed. Regardless of the particular legal tradition, a signature, with very few exceptions, is not self-standing. Its legal effect will depend on the link between the signature and the person to whom the signature is attributable. In practice, various steps may be taken to verify the identity of the signatory. When the parties are all present at the same place at the same time, they may simply recognize one another by their faces; if they negotiate over the telephone, they may recognize each other’s voices and so on. Much of this happens as a matter of course and is not subject to specific legal rules. However, where the parties negotiate by correspondence, or where signed documents are forwarded along a contracting chain, there may be few means of establishing that the signs that appear on a given document were indeed made by the person to whose name they appear to be linked and whether indeed only the duly authorized person was the one who produced the signature supposed to bind a particular person.

10. Although a manual signature is a familiar form of “authentication” and serves well for transaction documents passing between known parties, in many commercial and administrative situations a signature is therefore relatively insecure. The person relying on the document often has neither the names of persons authorized to sign nor specimen signatures available for comparison.³⁵ This is particularly true of many documents relied upon in foreign countries in international trade transactions. Even where a specimen of the authorized signature is available for comparison, only an expert may be able to detect a careful forgery. Where large numbers of documents are processed, signatures are sometimes not even compared except for the most important transactions. Trust is one of the basic foundations of international business relations.

³⁴ Ibid.

³⁵ Some areas of the law recognize both the inherent insecurity of handwritten signatures and the impracticability of insisting on strict form requirements for the validity of legal acts, and admit that in some instances even the forgery of a signature would not deprive a document of its legal effect. Thus, for example, article 7 of the Uniform Law on Bills of Exchange and Promissory Notes annexed to the Convention providing a Uniform Law for Bills of Exchange and Promissory Notes, done at Geneva on 7 June 1930, provides that “if a bill of exchange bears the signatures of persons incapable of binding themselves by a bill of exchange, or forged signatures, or signatures of fictitious persons, or signatures which for any other reason cannot bind the persons who signed the bill of exchange or on whose behalf it was signed, the obligations of the other persons who signed it are none the less valid” (League of Nations, *Treaty Series*, vol. CXLIII, No. 3313).

11. Most legal systems have special procedures or requirements that are intended to enhance the reliability of handwritten signatures. Some procedures may be mandatory in order for certain documents to produce legal effects. They may also be optional and available to parties that wish to act to preclude possible arguments concerning the authenticity of certain documents. Typical examples include the following:

(a) **Notarization.** In certain circumstances, the act of signing has a particular formal significance due to the reinforced trust associated with a special ceremony. This is the case, for instance, with notarization, i.e. the certification by a notary public to establish the authenticity of a signature on a legal document;

(b) **Attestation.** Attestation is the act of watching someone sign a legal document and then signing one's name as a witness. The purpose of attestation is to preserve evidence of the signing. By attesting, the witness states and confirms that the person whom he or she watched sign the document in fact did so. Attesting does not extend to vouching for the accuracy or truthfulness of the document. The witness can be called on to testify as to the circumstances surrounding the signing;³⁶

(c) **Seals.** The practice of using seals in addition to, or in substitution of signatures, is not uncommon, especially in certain regions of the world.³⁷ Signing or sealing may, for example, provide evidence of the identity of the signatory; that the signatory agreed to be bound by the agreement and did so voluntarily; that the document is final and complete; or that the information has not been altered after signing.³⁸ It may also caution the signatory and indicate the intent to act in a legally binding manner.

12. Apart from these special situations, handwritten signatures have been used in commercial transactions, both domestic and international, for centuries without any particularly designed legislative or operational framework. The addressees or holders of the signed documents have assessed the reliability of signatures on a case-by-case basis depending on the level of trust enjoyed by the signatory. In fact, the vast majority of international written contracts — if there is “writing” at all — are not necessarily accompanied by any special formality or authentication procedure.

13. Cross-border use of signed documents becomes more complicated when public authorities are involved, as receiving authorities in a foreign country typically require some evidence of the identity and authority of the signatory. These requirements are traditionally satisfied by so-called “legalization” procedures, where the signatures are contained in domestic documents, authenticated by diplomatic authorities for use abroad. Conversely, consular or diplomatic representatives of the country where the documents are intended to be used may also authenticate signatures of foreign public authorities in the country of origin. Often consular and diplomatic authorities only authenticate signatures of certain high-ranking authorities in the issuing countries, thus requiring several layers of

³⁶ Adrian McCullagh, Peter Little and William Caelli, “Electronic signatures: understand the past to develop the future”, *University of New South Wales Law Journal*, vol. 21, No. 2 (1998), see especially chapter III, section D, on the concept of witnessing.

³⁷ Seals are used in several countries in eastern Asia, such as China and Japan.

³⁸ Mark Sneddon, “Legislating to facilitate electronic signatures and records: exceptions, standards and the impact of the statute book”, *University of New South Wales Law Journal*, vol. 21, No. 2 (1998), see especially part 2, chapter II, on policy objectives of writing and signature requirements.

recognition of signatures where the document was originally issued by a lower-ranking official, or require prior notarization of signatures by a notary in the issuing country. Legalization is in most cases a cumbersome, time-consuming and expensive procedure. The Convention Abolishing the Requirement of Legalisation for Foreign Public Documents,³⁹ done at The Hague on 5 October 1961, was therefore negotiated to replace existing requirements with a simplified and standardized form (the “apostille”), which is used for providing a certification of certain public documents in the States parties to the Convention.⁴⁰ Only a “Competent Authority” designated by the State from which the public document emanates may issue an apostille. Apostilles certify the authenticity of the signature, the capacity in which the person signing the document has acted and, where appropriate, the identity of the seal or stamp that the document bears, but do not relate to the content of the underlying document itself.

14. As has been indicated above, in many legal systems, commercial contracts need not always to be contained in a document or evidenced by a writing to be valid. Even where a writing exists, a signature is not necessarily mandatory in order for the contract to be binding on the parties. Of course, where the law requires contracts to be in writing or to be signed, failure to meet those requirements would render the contract invalid. Perhaps more significant than form requirements for purposes of validity of contracts, are form requirements for evidentiary purposes. The difficulty of proving oral agreements is one of the main reasons why commercial contracts are reflected in written documents or documented by correspondence, even if an oral agreement would be otherwise valid. Parties whose obligations are documented in signed writings are unlikely to succeed in attempts to negate the content of their obligations. Strict rules on documentary evidence typically aim at affording a high degree of reliability on the documents that meet them, which is generally believed to raise legal certainty. At the same time, however, the more elaborate the evidentiary requirements, the greater the opportunity a party has to invoke formal defects with a view to invalidating or denying enforceability to obligations they no longer intend to perform, for instance because the contract has become commercially disadvantageous. The interest for promoting security in the exchange of electronic communications needs therefore to be balanced against the risk of providing an easy way for traders in bad faith to repudiate their freely assumed legal obligations. Achieving this balance through rules and standards that are internationally recognized and operable across national borders is a major task of policymaking in the area of electronic commerce. The purpose of the present document is to help legislators and policymakers to identify the main legal issues involved in international use of electronic authentication and signature methods and consider possible solutions for them.

³⁹ United Nations, *Treaty Series*, vol. 527, No. 7625. Available at the apostille section on the website of the Hague Conference on Private International Law at http://hcch.e-vision.nl/index_en.php?act=text.display&tid=37, accessed on 7 February 2007.

⁴⁰ Those documents include documents emanating from an authority or official connected with a court or tribunal of the State (including documents issued by an administrative, constitutional or ecclesiastical court or tribunal, a public prosecutor, a clerk or a process-server); administrative documents; notarial acts; and official certificates that are placed on documents signed by persons in their private capacity.

Part One

Electronic signature and authentication methods

I. Definition and methods of electronic signature and authentication

A. General remarks on terminology

15. The terms “electronic authentication” or “electronic signature” are used to refer to various techniques currently available on the market or still under development for the purpose of replicating in an electronic environment some or all of the functions identified as characteristic of handwritten signatures or other traditional authentication methods.

16. A number of different electronic signature techniques have been developed over the years. Each technique aims at satisfying different needs and providing different levels of security, and entails different technical requirements. Electronic authentication and signature methods may be classified in three categories: those based on the knowledge of the user or the recipient (e.g. passwords, personal identification numbers (PINs)), those based on the physical features of the user (e.g. biometrics) and those based on the possession of an object by the user (e.g. codes or other information stored on a magnetic card).⁴¹ A fourth category might include various types of authentication and signature methods that, without falling under any of the above categories, might also be used to indicate the originator of an electronic communication (such as a facsimile of a handwritten signature, or a name typed at the bottom of an electronic message). Technologies currently in use include digital signatures within a PKI, biometric devices, PINs, user-defined or assigned passwords, scanned handwritten signatures, signature by means of a digital pen, and clickable “OK” or “I accept” boxes.⁴² Hybrid solutions based on the combination of different technologies are becoming increasingly popular, such as, for instance, in the case of the combined use of passwords and TLS/SSL (transport layer security/secure sockets layer), which is a technology using a mix of public and symmetric key encryptions. The features of the main techniques currently used are described below (see paras. [...]–[...]).

17. As is often the case, technology developed long before the law entered this area. The resulting gap between law and technology leads not only to varying levels of expert knowledge, but also inconsistent use of terminology. Expressions that were traditionally used with a particular connotation under national laws started to be used to describe electronic techniques whose functionality did not necessarily coincide with the functions or characteristics of the corresponding concept in legal usage. As has been seen above (see paras. [...]–[...]), the notions of “authentication”, “authenticity”, “signature” and “identity”, although in certain contexts closely related, are not identical or interchangeable. The usage in the

⁴¹ See report of the Working Group on Electronic Commerce on the work of its thirty-second session, held in Vienna from 19 to 30 January 1998 (A/CN.9/446), paras. 91 ff., available at www.uncitral.org/uncitral/en/commission/working_groups/4Electronic_Commerce.html.

⁴² *UNCITRAL Model Law on Electronic Signatures with Guide to Enactment 2001* (see note [33]), part two, para. 33.

information technology industry, which evolved essentially around concerns over network security, however, does not necessarily apply the same categories as legal writings.

18. In some cases, the expression “electronic authentication” is used to refer to techniques that, depending on the context in which they are used, may involve various elements, such as identification of individuals, confirmation of a person’s authority (typically to act on behalf of another person or entity) or prerogatives (for example, membership in an institution, or subscription of a service) or assurance as to the integrity of information. In some cases, the focus is on identity only,⁴³ but sometimes it extends to authority,⁴⁴ or a combination of any or all of those elements.⁴⁵

19. Neither the UNCITRAL Model Law on Electronic Commerce,⁴⁶ nor the UNCITRAL Model Law on Electronic Signatures⁴⁷ uses the term “electronic authentication”, in view of the different meaning of “authentication” in various legal systems and the possible confusion with particular procedures or form requirements (see paras. [...]–[...] above). The Model Law on Electronic Commerce uses instead the notion of “original form” to provide the criteria for the functional equivalence of “authentic” electronic information. According to article 8 of the Model law, where the law requires information to be presented or retained in its original form, that requirement is met by a data message if:

(a) There exists “a reliable assurance as to the integrity of the information from the time when it was first generated in its final form, as a data message or otherwise;” and

(b) Where it is required that information be presented, that information “is capable of being displayed to the person to whom it is to be presented.”

⁴³ The Technology Administration of the United States Department of Commerce, for example, defines electronic authentication as “the process of establishing confidence in user identities electronically presented to an information system” (United States, Department of Commerce, *Electronic Authentication Guideline: Recommendations of the National Institute of Standards and Technology*, NIST Special Publication 800-63, version 1.0.2 (Gaithersburg, Maryland, April 2006)), available at http://csrc.nist.gov/publications/nistpubs/800-63/SP800-63V1_0_2.pdf, accessed on 4 April 2007.

⁴⁴ For example, the Government of Australia developed an electronic authentication framework that defines electronic authentication as “the process of establishing a level of confidence in whether a statement is genuine or valid when conducting a transaction online or by phone. It helps build trust in an online transaction by giving the parties involved some assurance that their dealings are legitimate. These statements might include: identity details; professional qualifications; or the delegated authority to conduct transactions” (Australia, Department of Finance and Administration, *Australian Government e-Authentication Framework: An Overview* (Commonwealth of Australia, 2005), available at www.agimo.gov.au/infrastructure/authentication/agaf_b/overview/introduction#e-authentication, accessed on 4 April 2007).

⁴⁵ The Principles for Electronic Authentication prepared by the Government of Canada, for instance, define “authentication” as “a process that attests to the attributes of participants in an electronic communication or to the integrity of the communication.” “Attributes” in turn are defined as “information concerning the identity privilege or rights of a participant or other authenticated entity” (Canada, Industry Canada, *Principles for Electronic Authentication: a Canadian Framework* (Ottawa, May 2004), available at http://strategis.ic.gc.ca/epic/site/ecic-ceac.nsf/en/h_gv00240e.html, accessed on 4 April 2007).

⁴⁶ UNCITRAL Model Law on Electronic Commerce with Guide to Enactment (see note [33]).

⁴⁷ UNCITRAL Model Law on Electronic Signatures (see note [33]).

20. In keeping with the distinction made in most legal systems between signature (or seals, where they are used instead) as a means of “authentication”, on the one hand, and “authenticity” as the quality of a document or record on the other, both model laws complement the notion of “originality” with the notion of “signature”. Article 2, subparagraph (a), of the UNCITRAL Model Law on Electronic Signatures defines electronic signature as: data in electronic form in, affixed to or logically associated with, a data message, which may be used to “identify the signatory” in relation to the data message and to “indicate the signatory’s approval of the information contained in the data message.”

21. The definition of “electronic signature” in UNCITRAL texts is deliberately broad, so as to encompass all existing or future “electronic signature” methods. As long as the methods used are “as reliable as was appropriate for the purpose for which the data message was generated or communicated, in the light of all the circumstances, including any relevant agreement”,⁴⁸ they should be regarded as meeting legal signature requirements. UNCITRAL texts relating to electronic commerce, as well as a large number of other legislative texts, are based on the principle of technological neutrality and therefore aim at accommodating all forms of electronic signature. Thus, UNCITRAL’s definition of electronic signature would cover the entire spectrum of “electronic signature” techniques, from higher-level security, such as cryptographically based signature assurance schemes associated with a PKI scheme (a common form of “digital signature” (see paras. [...]–[...]) to lower levels of security, such as unencrypted codes or passwords. The simple typing of the author’s name at the end of an e-mail message, which is the most common form of electronic “signature”, would, for instance, fulfil the function of correctly identifying the author of the message whenever it was not unreasonable to use such a low level of security.

22. The UNCITRAL model laws do not deal otherwise with issues related to access control or identity verification. This was also in keeping with the fact that, in a paper-based environment, signatures may be signs of identity but are necessarily attributive of identity (see paras. [...]–[...]). The UNCITRAL Model Law on Electronic Commerce deals, however, with the conditions under which the addressee of a data message is entitled to assume that the message actually originated from its purported originator. Indeed, article 13 of the Model Law provides that as between the originator and the addressee, a data message is deemed to be that of the originator if it was sent: by a person “who had the authority to act on behalf of the originator in respect of that data message”; or by “an information system programmed by, or on behalf of, the originator to operate automatically.” As between the originator and the addressee, an addressee is entitled to regard a data message as being that of the originator, and to act on that assumption, if (a) in order to ascertain whether the data message was that of the originator, “the addressee properly applied a procedure previously agreed to by the originator for that purpose;” or (b) the data message as received by the addressee resulted from the actions of a person whose relationship with the originator or with any agent of the originator enabled that person to gain access to a method used by the originator to identify data messages as its own. As a whole, these rules allow a party to infer someone else’s identity, whether or not the message was electronically “signed” and whether or not the method used for attributing the message to the originator could be validly used for “signature” purposes. This conforms to current practice in the

⁴⁸ *UNCITRAL Model Law on Electronic Commerce with Guide to Enactment* (see note [33]), article 7, subparagraph 1 (b).

paper-based environment. Checking someone else's voice, physical appearance or identity papers (for example, a national passport) may suffice to conclude that the person is who he or she purports to be for the purpose of communicating with the person concerned, but would not qualify as a "signature" of such person under most legal systems.

23. Besides the confusion that has been caused by the fact that technical and legal usage of terms in the paper-based and in the electronic environment do not coincide, the various techniques mentioned earlier (see above, para. [16] and the more detailed discussion in paras. [...] below) can be used for different purposes and provide a different functionality, depending on the context. Passwords or codes, for example, may be used to "sign" an electronic document, but they may also be used to gain access to a network, a database or another electronic service, in much the same way as a key may be used to unlock a safe or open a door. However, while in the first instance the password is a proof of **identity**, in the second instance, it is a **credential** or sign of authority, which, while ordinarily linked to a particular person, is also capable of being transferred to another. In the case of digital signatures, the inappropriateness of the current terminology is even more patent. The digital signature is widely regarded as a particular technology for "signing" electronic documents. However, it is at least questionable whether, from a legal point of view, the application of asymmetric cryptography for authentication purposes should be referred to as a digital "signature", as its functions go beyond the typical functions of a handwritten signature. The digital signature offers means both to "verify the authenticity of electronic messages" and "guarantee the integrity of the contents."⁴⁹ Furthermore, digital signature technology "does not merely establish origin or integrity with respect to individuals as is required for signing purposes, but it can also authenticate, for instance, servers, websites, computer software, or any other data that is distributed or stored digitally", which gives digital signatures "much broader use than an electronic alternative for handwritten signatures."⁵⁰

⁴⁹ Babette Aalberts and Simone van der Hof, *Digital Signature Blindness: Analysis of Legislative Approaches toward Electronic Authentication* (November 1999), p. 8, available at <http://rechten.uvt.nl/simone/Digsigbl.pdf>, accessed on 4 April 2007.

⁵⁰ Ibid.

A/CN.9/630/Add.1 [Original: English]

**Comprehensive reference document on elements required to
establish a favourable legal framework for electronic commerce:
sample chapter on international use of electronic
authentication and signature methods**

ADDENDUM

The annex to the present note contains part of a sample chapter (part one, chap. I, sects. B and C) of a comprehensive reference document dealing with legal issues related to the international use of electronic authentication and signature methods.

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Part One**Electronic signature and authentication methods**

[...]

I. Definition and methods of electronic authentication and signature

[...]

B. Main methods of electronic signature and authentication

1. For the purposes of this discussion, four main signature and authentication methods will be discussed: digital signatures; biometric methods; passwords and hybrid methods; and scanned or typed signatures.

1. Digital signatures relying on public key cryptography

2. “Digital signature” is a name for technological applications using asymmetric cryptography, also referred to as public key encryption systems, to ensure the authenticity of electronic messages and guarantee the integrity of the contents of these messages. The digital signature has many different appearances, such as fail-stop digital signatures, blind signatures and undeniable digital signatures.

(a) Technical notions and terminology

(i) *Cryptography*

3. Digital signatures are created and verified by using cryptography, the branch of applied mathematics that is concerned with transforming messages into a seemingly unintelligible form and then back into their original form. Digital signatures use what is known as public key cryptography, which is often based on the use of algorithmic functions to generate two different but mathematically related “keys” (i.e. large numbers produced using a series of mathematical formulae applied to prime numbers).¹ One such key is used for creating a digital signature or transforming data into a seemingly unintelligible form, and the other key is used for verifying a digital signature or returning the message to its original form.² Computer equipment and software utilizing two such keys are often collectively referred to as “cryptosystems” or, more specifically, “asymmetric cryptosystems” where they rely on the use of asymmetric algorithms.

(ii) *Public and private keys*

4. A complementary key used for digital signatures is named the “private key”, which is used only by the signatory to create the digital signature and should be kept secret, while the “public key” is ordinarily more widely known and is used by a relying party to verify the digital signature. The private key is likely to be kept on a

¹ It should be noted, however, that the concept of public key cryptography, as discussed here, does not necessarily imply the use of algorithms based on prime numbers. Other mathematical techniques are currently used or under development, such as cryptosystems relying on elliptic curves, which are often described as offering a high degree of security through the use of significantly reduced key-lengths.

² While the use of cryptography is one of the main features of digital signatures, the mere fact that a digital signature is used to authenticate a message containing information in digital form should not be confused with a more general use of cryptography for purposes of confidentiality. Confidentiality encryption is a method used for encoding an electronic communication so that only the originator and the addressee of the message will be able to read it. In a number of countries, the use of cryptography for confidentiality purposes is limited by law for reasons of public policy that may involve considerations of national defense. However, the use of cryptography for authentication purposes by producing a digital signature does not necessarily imply the use of cryptography to make any information confidential in the communication process, since the encrypted digital signature may be merely appended to a non-encrypted message.

smart card or to be accessible through a personal identification number (PIN) or a biometric identification device, such as thumbprint recognition. If many people need to verify the signatory's digital signature, the public key must be available or distributed to all of them, for example by attaching the certificates to the signature or by other means that ensure that the relying parties, and only those who have to verify the signatures, can obtain the related certificates. Although the keys of the pair are mathematically related, if an asymmetric cryptosystem has been designed and implemented securely it is virtually impossible to derive the private key from knowledge of the public key. The most common algorithms for encryption through the use of public and private keys are based on an important feature of large prime numbers: once they are multiplied together to produce a new number, it is particularly difficult and time-consuming to determine which two prime numbers created that new, larger number.³ Thus, although many people may know the public key of a given signatory and use it to verify that signatory's signature, they cannot discover that signatory's private key and use it to forge digital signatures.

(iii) *Hash function*

5. In addition to the generation of key pairs, another fundamental process, generally referred to as a "hash function", is used in both creating and verifying a digital signature. A hash function is a mathematical process, based on an algorithm that creates a digital representation or compressed form of the message (often referred to as a "message digest" or "fingerprint" of the message), in the form of a "hash value" or "hash result" of a standard length that is usually much smaller than the message but nevertheless substantially unique to it. Any change to the message invariably produces a different hash result when the same hash function is used. In the case of a secure hash function, sometimes called a "one-way hash function", it is virtually impossible to derive the original message from knowledge of its hash value. Another basic feature of hash functions is that it is also virtually impossible to find another binary object (i.e. different from the one from which the digest was originally derived) producing the same digest. Hash functions therefore enable the software for creating digital signatures to operate on smaller and more predictable amounts of data, while still providing robust evidentiary correlation to the original message content, thereby efficiently providing assurance that there has been no modification of the message since it was digitally signed.

(iv) *Digital signature*

6. To sign a document or any other item of information, the signatory first delimits precisely the borders of what is to be signed. Then a hash function in the signatory's software computes a hash result unique (for all practical purposes) to the information to be signed. The signatory's software then transforms the hash result

³ Certain existing standards refer to the notion of "computational unfeasibility" to describe the expected irreversibility of the process, that is, the hope that it will be impossible to derive a user's secret private key from that user's public key. "'Computationally unfeasible' is a relative concept based on the value of the data protected, the computing overhead required to protect it, the length of time it needs to be protected, and the cost and time required to attack the data, with such factors assessed both currently and in the light of future technological advance." (American Bar Association, *Digital Signature Guidelines: Legal Infrastructure for Certification Authorities and Secure Electronic Commerce* (Chicago, American Bar Association, 1 August 1996), p. 9, note 23, available at www.abanet.org/scitech/ec/isc/dsgfree.html, accessed on 5 April 2007).

into a digital signature using the signatory's private key. The resulting digital signature is thus unique to both the information being signed and the private key used to create the digital signature. Typically, a digital signature (the encryption with the signer's private key of the hash result of the message) is attached to the message and stored or transmitted with that message. However, it may also be sent or stored as a separate data element, as long as it maintains a reliable association with the corresponding message. Since a digital signature is unique to its message, it is inoperable if permanently disassociated from the message.

(v) *Verification of digital signature*

7. Digital signature verification is the process of checking the digital signature by reference to the original message and a given public key, thereby determining whether the digital signature was created for that same message using the private key that corresponds to the referenced public key. Verification of a digital signature is accomplished by computing a new hash result for the original message, by means of the same hash function used to create the digital signature. Then, using the public key and the new hash result, the verifier checks whether the digital signature was created using the corresponding private key and whether the newly computed hash result matches the original hash result that was transformed into the digital signature during the signing process.

8. The verification software will confirm the digital signature as "verified" from a cryptographic viewpoint if (a) the signatory's private key was used to sign digitally the message, which is known to be the case if the signatory's public key was used to verify the signature because the signatory's public key will verify only a digital signature created with the signatory's private key; and (b) the message was unaltered, which is known to be the case if the hash result computed by the verifier is identical to the hash result extracted from the digital signature during the verification process.

(vi) *Other uses of digital signature technology*

9. As indicated above, digital signature technology has a much broader use than merely to "sign" electronic communications in the same manner that handwritten signatures are used to sign documents (see paragraph [...]). Indeed, digitally signed certificates are often used, for instance, to "authenticate" servers or websites, for example in order to guarantee to their users that the server or website is the one it purports to be, or is genuinely attached to the company that claims to run the server or website. Digital signature technology can also be used to "authenticate" computer software, for example in order to guarantee the authenticity of a software downloaded from a website; or in order to guarantee that a particular server uses a technology that is widely recognized as providing a certain level of connection security, or in order to "authenticate" any other data that is distributed or stored digitally.

(b) **Public key infrastructure and certification services providers**

10. To verify a digital signature, the verifier must have access to the signatory's public key and have assurance that it corresponds to the signatory's private key. However, a public-key and private-key pair has no intrinsic association with any person; it is simply a pair of numbers. An additional mechanism is necessary to associate reliably a particular person or entity to the key pair. This is particularly

important, as there may be no pre-existing relationship of trust between the signatory and the recipients of digitally signed communications. To that effect, the parties involved must have a degree of confidence in the public and private keys being issued.

11. The required level of confidence may exist between parties who trust each other, who have dealt with each other over a period of time, who communicate on closed systems, who operate within a closed group or who are able to govern their dealings contractually, for example in a trading partner agreement. In a transaction involving only two parties, each party can simply communicate (by a relatively secure channel such as by courier or telephone) the public key of the key pair each party will use. However, the same level of confidence may not be present when the parties deal infrequently with each other, communicate over open systems (e.g. the World Wide Web on the Internet), are not in a closed group, or do not have trading partner agreements or other laws governing their relationships. Moreover, it should be taken into account that, if disputes need be settled in court or by arbitration, it might be difficult to demonstrate that a certain public key had or had not actually been given to the recipient by its actual owner.

12. A prospective signatory might issue a public statement indicating that signatures verifiable by a given public key should be treated as originating from that signatory. The law of the enacting State would govern the form and the legal effectiveness of such a statement. For example, a presumption of attribution of electronic signatures to a particular signatory could be established through publication of the statement in an official bulletin or in a document recognized as “authentic” by public authorities. However, other parties might be unwilling to accept the statement, especially where there is no prior contract establishing the legal effect of that published statement with certainty. A party relying upon such an unsupported published statement in an open system would run a great risk of inadvertently trusting an impostor or of having to disprove a false denial of a digital signature (an issue often referred to in the context of “non-repudiation” of digital signatures) if a transaction should turn out to prove disadvantageous for the purported signatory.

13. One solution to some of these problems is the use of one or more third parties to associate an identified signatory or the signatory’s name with a specific public key. That third party is generally referred to as a “certification authority”, “certification services provider” or “supplier of certification services” in most technical standards and guidelines (in the UNCITRAL Model Law on Electronic Signatures,⁴ the term “certification service provider” has been chosen). In a number of countries, such certification authorities are being organized hierarchically into what is often referred to as a “public key infrastructure” (PKI). Certification authorities within a PKI can be established in a hierarchical structure, where some certification authorities only certify other certification authorities, which provide services directly to users. In such a structure, some certification authorities are subordinate to other certification authorities. In other conceivable structures, all certification authorities may operate on an equal footing. In any large PKI, there would likely be both subordinate and superior certification authorities. Other solutions may include, for example, certificates issued by relying parties.

⁴ See note [...] [United Nations publication, Sales No. E.02.V.8].

(i) *Public key infrastructure*

14. Setting up a PKI is a way to provide confidence that (a) a user's public key has not been changed and in fact corresponds to that user's private key; and (b) the cryptographic techniques being used are sound. To provide the confidence described above, a PKI may offer a number of services, including the following: (a) managing cryptographic keys used for digital signatures; (b) certifying that a public key corresponds to a private key; (c) providing keys to end users; (d) publishing revocation information of public keys or certificates; (e) managing personal tokens (e.g. smart cards) that can identify the user with unique personal identification information or can generate and store an individual's private keys; (f) checking the identification of end users and providing them with services; (g) providing time-stamping services; and (h) managing cryptographic keys used for confidentiality encryption where the use of such a technique is authorized.

15. A PKI may be based on various hierarchical levels of authority. For example, models considered in certain countries for the establishment of possible PKIs include references to the following levels: (a) a unique "root authority", which would certify the technology and practices of all parties authorized to issue cryptographic key pairs or certificates in connection with the use of such key pairs and would register subordinate certification authorities;⁵ (b) various certification authorities, placed below the "root" authority, which would certify that a user's public key actually corresponds to that user's private key (i.e. has not been tampered with); and (c) various local registration authorities, placed below the certification authorities, which would receive requests from users for cryptographic key pairs or for certificates in connection with the use of such key pairs, requiring proof of identification and checking identities of potential users. In certain countries, it is envisaged that notaries public might act as, or support, local registration authorities.

16. PKIs organized in a hierarchical structure are scalable in the sense that they may incorporate entire new PKI "communities" simply by having the "root authority" establish a trust relationship with the new community's "root".⁶ The root authority of the new community may be incorporated directly under the "root" of the receiving PKI, thus becoming a subordinate certification services provider within that PKI. The root authority of the new community may also become a subordinate certification services provider to one of the subordinate certification services providers within the existing PKI. Another attractive feature of hierarchical PKIs is that it makes it easy to develop certification paths because they run in one direction only, from a user's certificate back to the trust point. Furthermore, certification paths within a hierarchical PKI are relatively short and the users of a hierarchy know implicitly which applications a certificate may be used for, based on the position of the certification services provider within the hierarchy. However, hierarchical PKIs have drawbacks as well, mainly as a consequence of reliance on a single trust point. If the root authority is compromised, the entire PKI is compromised. Furthermore, some countries have found it difficult to select one

⁵ The question as to whether a Government should have the technical ability to retain or recreate private confidentiality keys may be dealt with at the level of the root authority.

⁶ William T. Polk and Nelson E. Hastings, *Bridge Certification Authorities: Connecting B2B Public Key Infrastructures*, National Institute of Standards and Technology (September 2000), available at <http://csrc.nist.gov/pki/documents/B2B-article.pdf>, accessed on 30 March 2007.

single entity as a root authority and to impose such a hierarchy on all other certification services providers.⁷

17. The so-called “mesh” PKI is an alternative to a hierarchical PKI. Under this model, certification services providers are connected in a peer-to-peer relationship. All certification services providers in such a model can be trust points. Generally, users will trust the certification services providers that issued their certificate. Certification services providers will issue certificates to each other; the pair of certificates describes their reciprocal trust relationship. The lack of hierarchy in such a system means that certification services providers cannot impose conditions governing the types of certificate issued by other certification services providers. If a certification services provider wishes to limit the trust extended to other certification services providers, it must specify these limitations in the certificates issued to its peers.⁸ Harmonizing conditions and limitations of mutual recognition may however be an extremely complex objective.

18. A third alternative structure is built around the so-called “bridge” certification services provider. This structure may be particularly useful to allow various pre-existing PKI communities to trust each other’s certificates. Unlike a certification services provider in a “mesh” PKI, a “bridge” certification services provider does not issue certificates directly to users. Neither is a “bridge” certification services provider intended to be used as a trust point by the users of the PKI, as would be the case with a “root” certification services provider. Instead, the “bridge” certification services provider establishes peer-to-peer trust relationships with the different user communities, thus allowing the users to keep their natural trust points within their respective PKIs. If a user community implements a trust domain in the form of a hierarchical PKI, the “bridge” certification services provider will establish a relationship with the root authority of that PKI. However, if the user community implements a trust domain by creating a mesh PKI, the “bridge” certification services provider will only need to establish a relationship with one of the PKI’s certification services providers, which then becomes the “principal” certification services provider within that PKI for the purpose of establishing the “bridge of trust” to the other PKI. The “bridge of trust” that joins two or more PKIs through their mutual relationship with a “bridge” certification services provider enables users from the different user communities to interact with each other through the “bridge” certification services provider with a specified level of trust.⁹

(ii) *Certification services provider*

19. To associate a key pair with a prospective signatory, a certification services provider (or certification authority) issues a certificate, which is an electronic record that lists a public key together with the name of the certificate subscriber as the “subject” of the certificate, and which may confirm that the prospective signatory identified in the certificate holds the corresponding private key. The principal function of a certificate is to bind a public key with a particular signatory. A “recipient” of the certificate desiring to rely upon a digital signature created by the

⁷ Polk and Hastings (see note [6]) note that in the United States of America, it was very difficult to single out one agency of the Federal Government to assume the overall authority over the federal PKI.

⁸ Polk and Hastings, *Bridge Certification Authorities ...* (see note [5]).

⁹ The “bridge” certification services provider was the structure eventually chosen to set up the PKI system for the United States Federal Government (Polk and Hastings, see note [6]). This was also the model followed to develop the PKI system of the Government of Japan.

signatory named in the certificate can use the public key listed in the certificate to verify that the digital signature was created with the corresponding private key. If such verification is successful, a level of assurance is provided technically that the signatory created the digital signature and that the portion of the message used in the hash function (and, consequently, the corresponding data message) has not been modified since it was digitally signed.

20. To assure the authenticity of the certificate with respect to both its contents and its source, the certification services provider digitally signs it. The issuing certification services provider's digital signature on the certificate can be verified by using the public key of the certification service provider listed in another certificate by another certification services provider (which may, but need not, be on a higher level in a hierarchy), and that other certificate can in turn be authenticated by the public key listed in yet another certificate, and so on, until the person relying on the digital signature is adequately assured of its genuineness. Recording the digital signature in a certificate issued by the certification services provider (sometimes referred to as a "root certificate") is another possible way of verifying a digital signature.¹⁰

21. In each case, the issuing certification services provider may digitally sign its own certificate during the operational period of the other certificate used to verify the certification services provider's digital signature. Under the laws of some States, one way of building trust in the digital signature of the certification services provider might be to publish the public key of the certification services provider or certain data pertaining to the root certificate (such as a "digital fingerprint") in an official bulletin.

22. A digital signature corresponding to a message, whether created by the signatory to authenticate a message or by a certification services provider to authenticate its certificate, should generally be reliably time stamped to allow the verifier to determine whether the digital signature was created during the "operational period" stated in the certificate, and in any case whether the certificate was valid (e.g. was not mentioned in a revocation list) at the relevant time, which is a condition of the verifiability of a digital signature.

23. To make a public key and its correspondence to a specific signatory readily available for verification, the certificate may be published in a repository, or made available by other means. Typically, repositories are online databases of certificates and other information available for retrieval and use in verifying digital signatures.

24. Once issued, a certificate may prove to be unreliable, for example in situations where the signatory misrepresents its identity to the certification services provider. In other circumstances, a certificate may be reliable enough when issued, but may become unreliable sometime afterwards. If the private key is "compromised", for example through loss of control of the private key by the signatory, the certificate may lose its trustworthiness or become unreliable, and the certification services provider (at the signatory's request or even without the signatory's consent, depending on the circumstances) may suspend (temporarily interrupt the operational period) or revoke (permanently invalidate) the certificate. In a timely fashion upon suspending or revoking a certificate, the certification services provider may be expected to publish a notice of the revocation or suspension, or to notify persons

¹⁰ *Official Records of the General Assembly, Fifty-sixth Session, Supplement No. 17 and corrigendum (A/56/17 and Corr.3), para. 279.*

who enquire or who are known to have received a digital signature verifiable by reference to the unreliable certificate. Similarly, where applicable, the certification services provider's own certificate should also be reviewed for possible revocation, as should the certificate issued for the verification of the signature of the time-stamping authority on the time-stamp tokens and the certificate of the certification services provider that issued the certificate of the time-stamping authority.

25. Certification authorities could be operated by private sector service providers or Government authorities. In a few countries, it is envisaged that, for public policy reasons, only Government entities should be authorized to operate as certification authorities. In most countries, however, certification services are either entirely left for the private sector or State-run certification services providers coexist with private sector providers. There are also closed certification systems, where small groups set up their own certification services provider. In some countries, State-owned certification services providers issue certificates only in support of digital signatures used by the public administration. Irrespective of whether certification authorities are operated by public entities or by private sector service providers, and of whether certification authorities would need to obtain a licence to operate, there is typically more than one certification services provider operating within the PKI. Of particular concern is the relationship between the various certification authorities (see paras. [15]-[18] above).

26. It may be incumbent upon the certification services provider or the root authority to ensure that its policy requirements are met on an ongoing basis. While the selection of certification authorities may be based on a number of factors, including the strength of the public key being used and the identity of the user, the trustworthiness of any certification services provider may also depend on its enforcement of standards for issuance of certificates and the reliability of its evaluation of data received from users who request certificates. Of particular importance is the liability regime applying to any certification services provider with respect to its compliance with the policy and security requirements of the root authority or superior certification services provider, or with any other applicable requirement, on an ongoing basis. Of equal importance is the obligation of the certification services provider to act in accordance with the representations made by it with respect to its policies and practices, as envisaged in article 9, paragraph 1 (a), of the Model Law on Electronic Signatures.

(c) Practical problems in public key infrastructure implementation

27. Despite the considerable knowledge of digital signature technologies and the way they function, the implementation of public key infrastructures and digital signature schemes has, in practice, faced some problems that have kept the level of use of digital signatures below expectations.

28. Digital signatures work well as a means to verify signatures that are created during the period of validity of a certificate. However, once the certificate expires or is revoked, the corresponding public key loses its validity, even if the key pair was not compromised. Accordingly, a PKI scheme would require a digital signature management system to ensure the availability of the signature over time. The main difficulty results from the risk that the "original" electronic records (that is, the binary digits, or "bits" that make up the computer file on which the information is recorded), including the digital signature, may become unreadable or unreliable over time, mainly because of the obsolescence of the software, the equipment or both. In fact, the digital signature may become insecure, as a consequence of

scientific advances in cryptanalysis, the signature verification software may not be available over long periods of time or the document may lose its integrity.¹¹ This makes the long-term retention of electronic signatures generally problematic. Even though digital signatures were for some time believed to be essential for archival purposes, experience has shown that they are not immune to long-term risks. Since every alteration to the record after the time when the signature was created will cause the verification of the signature to fail, reformatting operations intended to keep a record legible for the future (such as “migration”, or “conversion”) may affect the durability of the signature.¹² In fact, digital signatures were conceived more for providing security for the communication of information than for the preservation of information over time.¹³ Initiatives to overcome this problem have not yet resulted in a durable solution.¹⁴

¹¹ Jean-François Blanchette, “Defining electronic authenticity: an interdisciplinary journey”, available at <http://polaris.gseis.ucla.edu/blanchette/papers/dsn.pdf>, accessed on 5 April 2007 (paper published in a supplemental volume of the 2004 International Conference on Dependable Systems and Networks (DSN 2004), Florence, Italy, 28 June-1 July 2004), pp. 228-232.

¹² “In the end, all we can preserve in an electronic context are bits. However, it has been clear for a long time that it is very difficult to keep a set of bits indefinitely. With the lapse of time, the set of bits becomes illegible (to the computer and thus to humans) as a result of the technological obsolescence of the application program and/or of the hardware (e.g. the reader). The problem of the durability of PKI-based digital signatures has been poorly studied so far because of its complexity. ... Although the authentication tools that were used in the past, such as handwritten signatures, seals, stamps, fingerprints etc. are also subject to reformatting (e.g. microfilming) because of the obsolescence of the paper carrier, they never become completely useless after reformatting. There is always at least a copy available that can be compared with other original authentication tools.” (Jos Dumortier and Sofie Van den Eynde, *Electronic Signatures and Trusted Archival Services*, p. 5, available at www.law.kuleuven.ac.be/icri/publications/172DLM2002.pdf?where, accessed on 5 April 2007.

¹³ In 1999, archivists from various countries launched the International Research on Permanent Authentic Records in Electronic Systems (InterPARES) project with the aim of “developing the theoretical and methodological knowledge essential to the long-term preservation of authentic records created and/or maintained in digital form” (see www.interpares.org, accessed on 5 April 2007). The draft report of the Authenticity Task Force, which was part of the first phase of the project (InterPARES 1, concluded in 2001), indicated that “digital signatures and public key infrastructures (PKI) are examples of technologies that have been developed and implemented as a means of authentication for electronic records that are transmitted **across space**. Although record-keepers and information technology personnel place their trust in authentication technologies to ensure the authenticity of records, these technologies were never intended to be, and are not currently viable as, a means of ensuring the authenticity of electronic records **over time**” (emphasis added), available at www.interpares.org/documents/atf_draft_final_report.pdf, accessed on 5 April 2007. The final report of InterPARES 1 is available at www.interpares.org/book/index.htm. The continuation of the project (InterPARES 2), aims to develop and articulate the concepts, principles, criteria and methods that can ensure the creation and maintenance of accurate and reliable records and the long-term preservation of authentic records in the context of artistic, scientific and Government activities developed from 1999 and 2001.

¹⁴ The European Electronic Signature Standardization Initiative (EESSI), for example, was created in 1999 by the Information and Communications Technology Standards Board, a collaborative group of organizations concerned with standardization and related activities in information and communications technologies established to coordinate the standardization activity in support to the implementation of European Union Directive on electronic signatures (see note [...]) [Official Journal of the European Communities, L 13/12]. The EESSI consortium (a standardization effort which seeks to translate the requirements of the European directive on electronic signatures into European standards) has sought to address the need for ensuring the

29. Another area where digital signatures and PKI schemes may give rise to practical problems concerns data security and privacy protection. Certification services providers must keep safe the keys used to sign certificates issued to their customers and may be exposed to attempts by outsiders to gain unauthorized access to the keys (see also part two, paras. [...] below). Furthermore, certification services providers need to obtain a series of personal data and business information from persons applying for certificates. This information needs to be stored by the certification services provider for future reference. Certification services providers must take the necessary measures to ensure that access to such information is in accordance with applicable data protection laws.¹⁵ However, unauthorized access remains a real threat.

2. Biometrics

30. A biometric is a measurement used to identify an individual through its intrinsic physical or behavioural traits. Traits that may be used for recognition in

long-term preservation of cryptographically signed documents through its standard on Electronic Signature Formats (Electronic Signature Formats ES 201 733, ETSI, 2000). The format distinguishes between signature validation moments: the initial validation and a later validation. The format for late validation encapsulates all of the information that can eventually be used in the validation process, such as revocation information, time stamps, signature policies, etc. This information is gathered at the stage of initial validation. The designers of these electronic signature formats were concerned with the security threat to the validity of the signature that results from decay in cryptographic strength. To guard against this threat of decay, EESSI signatures are regularly time stamped afresh, with signing algorithms and key sizes appropriate to state-of-the-art cryptanalytic methods. The problem of software longevity has been addressed in a 2000 report by EESSI, which introduced “trusted archival services”, a new type of commercial service that would be offered by yet to be specified competent bodies and professions, in order to guarantee the long-term preservation of cryptographically signed documents. The report lists a number of technical requirements such archival services should provide, among them, “backward compatibility” with computer hardware and software, through either preservation of equipment and/or emulation (see Blanchette, “Defining electronic authenticity...” (see note [12])). A follow-up study on the EESSI recommendation on trusted archival services by the Interdisciplinary Centre for Law and Information Technology of the Katholieke Universiteit Leuven (Catholic University of Leuven), Belgium, entitled *European Electronic Signature Standardization Initiative: Trusted Archival Services* (Phase 3, final report, 28 August 2000) is available at www.law.kuleuven.ac.be/icri/publications/91TAS-Report.pdf?where=, accessed on 12 April 2007). EESSI was closed in October 2004. Systems to implement these recommendations do not seem to be currently in operation (see Dumortier and Van den Eynde, *Electronic Signatures and Trusted Archival Services* (see note [13])).

¹⁵ See Organization for Economic Cooperation and Development (OECD) Guidelines on the Protection of Privacy and Transborder Flows of Personal Data (Paris, 1980) available at www.oecd.org/document/18/0,2340,en_2649_34255_1815186_1_1_1_1,00.html, accessed on 7 February 2007; Council of Europe Convention for the Protection of Individuals with regard to Automatic Processing of Personal Data (Council of Europe, *European Treaty Series*, No. 108), available at <http://conventions.coe.int/Treaty/en/Treaties/Html/108.htm>, accessed on 7 February 2007; Guidelines for the regulation of computerized personal data files (General Assembly resolution 45/95), available at <http://193.194.138.190/html/menu3/b/71.htm>, accessed on 7 February 2007; and Directive 95/46/EC of the European Parliament and of the Council of 24 October 1995 on the protection of individuals with regard to the processing of personal data and on the free movement of such data (*Official Journal of the European Communities*, L 281, 23 November 1995), available at http://eur-lex.europa.eu/smartapi/cgi/sga_doc?smartapi!celexapi!prod!CELEXnumdoc&lg=EN&numdoc=31995L0046&model=guichett, accessed on 7 February 2007.

biometrics include DNA, fingerprint, iris, retina, hand or facial geometry, facial thermogram, ear shape, voice, body odour, blood vessel pattern, handwriting, gait and typing patterns.

31. The use of biometric devices typically involves capturing a biometric sample of a biological feature of an individual. This sample is in the digital form. Then, biometric data is extracted from that sample to create a reference template. Eventually, the biometric data stored in the reference template is compared with the one extracted from the end user for the purpose of verification, so that it is possible to indicate whether or not an identification or verification of identity has been achieved.¹⁶

32. The nature of biometric devices entails unique features that need to be taken into due consideration. The existence of those features, which may to some extent differ with the trait chosen as a reference, has a major impact on the suitability of the technology for the intended application.

33. A number of risks relate to the storage of biometrical data since biometric patterns are typically not revocable. When biometric systems have been compromised, the legitimate user has no recourse but to revoke the identification data and switch to another set of uncompromised identification data. Therefore, special rules are needed to prevent the abuse of biometrics databases.

34. The accuracy of biometric techniques cannot be absolute since biological features tend to be inherently variable and any measurement may involve deviation. In this respect, biometrics are not considered unique identifiers but rather semi-unique identifiers. To accommodate those variations, the accuracy of biometrics may be manipulated by setting the threshold for matching the reference template with the extracted sample. However, a low threshold may bias the test towards false acceptance while a high threshold may tend towards false rejections. Nevertheless, the accuracy of authentication provided by biometrics may be adequate in the majority of commercial applications.

35. Moreover, data protection and human rights issues arise in relation to the storage and disclosure of biometrical data. Data protection laws,¹⁷ although they may not refer expressly to biometrics, aim at protecting personal data relating to natural persons, whose processing, both in their raw form and as templates, is at the core of biometrics technology.¹⁸ Moreover, measures may be required to protect consumers against risks generated by the private use of biometric data, as well as in case of identity theft. Other legal domains, including labour and health law, may also come into play.¹⁹

¹⁶ International Association for Biometrics (iAfb) and International Computer Security Association (ICSA), *1999 Glossary of Biometric Terms*, available at www.afb.org.uk/docs/glossary.htm, accessed on 7 February 2007.

¹⁷ See note [15].

¹⁸ Paul de Hert, *Biometrics: Legal Issues and Implications*, background paper for the Institute for Prospective Technological Studies of the European Commission (European Communities, Directorate General Joint Research Centre, 2005), p. 13, available at http://cybersecurity.jrc.es/docs/LIBE%20Biometrics%20March%202005/LegalImplications_Paul_de_Hert.pdf.

¹⁹ For instance, in Canada, the use of biometrics was discussed with respect to the application of the Personal Information Protection and Electronic Documents Act (2000, c. 5) in the workplace (see *Turner v. TELUS Communications Inc.*, 2005 FC 1601, 29 November 2005 (Federal Court of Canada)).

36. Technical solutions might assist in addressing some concerns. For instance, storage of biometrical data on smart cards or tokens may protect from unauthorized access, which could occur if the data is stored on a centralized computer system. Moreover, best practices have been developed to reduce risks in different areas such as scope and capabilities; data protection; user control of personal data; and disclosure, auditing, accountability and oversight.²⁰

37. Biometric devices are generally considered as offering a high level of security. While they are compatible with a range of uses, their current main scope is on Government applications, particularly law enforcement applications such as immigration clearance and access controls.

38. Commercial applications have also been developed, where often biometrics are used in the context of a two-factor authentication process requiring provision of an element in possession of the individual (biometrics) and an element in the knowledge of the individual (typically, a password or a PIN). Moreover, applications were developed to store and compare the characteristics of a person's handwritten signature. Digital-based pen tablets record the pen pressure and duration of the signing process. The data are then stored as an algorithm to be used for comparison against future signatures. However, in light of the inherent features of biometrics, caution is also expressed on the dangers of a gradual, uncontrolled increase relating to their use in routine commercial transactions.

39. If biometric signatures are used as a substitute for handwritten signatures, a problem of evidence may arise. As mentioned before, the reliability of biometric evidence varies between the technologies used and the chosen false acceptance rate. Besides, there is the possibility to tamper with or falsify the biometric data stored in digital form.

40. The general reliability tests under the UNCITRAL Model Law on Electronic Signatures²¹ and Model Law on Electronic Commerce,²² as well as under the more recent United Nations Convention on the Use of Electronic Communications in International Contracts,²³ can be applied to the use of biometric signatures. To ensure uniformity, it might also be useful to develop international guidelines on the use and management of biometric methods.²⁴ Whether such standards would be premature, given the current state of development of biometric technologies, and might risk hampering the continued development of biometric technologies, needs to be carefully considered.

²⁰ See, for an example of best practices, the International Biometric Group BioPrivacy Initiative, "Best practices for privacy-sympathetic biometric deployment", available at www.bioprivacy.org.

²¹ (See note [...]) [United Nations publication, Sales No. E.02.V.8].

²² (See note [...]) [United Nations publication, Sales No. E.99.V.4].

²³ The United Nations Convention on the Use of Electronic Communications in International Contracts was finalized by UNCITRAL at its thirty-eighth session (Vienna, 4-15 July 2005) and officially adopted by the General Assembly on 23 November 2005 (General Assembly resolution 60/21, annex), available at www.uncitral.org/uncitral/en/uncitral_texts/electronic_commerce/2005Convention.html.

²⁴ These could be compared with the criteria for reliability presented in the Guide to Enactment of the UNCITRAL Model Law on Electronic Signatures (see note [...]) [United Nations publication, Sales No. E.02.V.8], paragraph 75.

3. Passwords and hybrid methods

41. Passwords and codes are used both for controlling access to information or services and for “signing” electronic communications. In practice, the latter use is less frequent than the former, because of the risk of compromising the code if it is transmitted in non-encrypted messages. Passwords and codes are however the most widely used method for “authentication” for purposes of access control and identity verification in a broad range of transactions, including most Internet banking, cash withdrawals at automatic teller machines and consumer credit card transactions.

42. It should be recognized that multiple technologies can be used to “authenticate” an electronic transaction. Several technologies or several uses of a single technology can be utilized for a single transaction. For example, signature dynamics for authentication can be combined with cryptography for message integrity. Alternatively, passwords can be passed over the Internet, using cryptography (e.g. SSL in browsers) to protect them, in conjunction with the use of biometrics to trigger a digital signature (asymmetric cryptography), which, on receipt, generates a Kerberos ticket (symmetric cryptography). In developing legal and policy frameworks to deal with these technologies, consideration should be given to the role of multiple technologies. Legal and policy frameworks for electronic authentication will need to be flexible enough to cover hybrid technology approaches, as those that focus on specific technologies could impede the use of multiple technologies.²⁵ Technology neutral provisions would facilitate the acceptance of such hybrid technology approaches.

4. Scanned signatures and typed names

43. The main reason for legislative interest in electronic commerce in the private law area has been concern about how new technologies may affect the application of rules of law that were conceived for other media. This attention to technology has often led, deliberately or not, to a focus on sophisticated technologies that offer a higher level of security for electronic authentication and signature methods. It is often neglected, in that context, that a very large number, if not the majority, of business communications exchanged throughout the world do not make use of any particular authentication or signature technology.

44. In day-to-day practice, companies around the world are often satisfied, for instance, with exchanging e-mails without the use of any form of authentication or signature other than the typed name, title and address of parties at the bottom of their communications. Sometimes a more formal appearance is given by the use of facsimile or scanned images of handwritten signatures, which of course constitute only a copy in digitalized form of a handwritten original. Neither typed names on unencrypted e-mails nor scanned signatures offer a high level of security or can definitely prove the identity of the originator of the electronic communication in which they appear. Nevertheless, business entities freely choose to use these forms of “authentication” in the interest of ease, expediency and cost-effectiveness of

* This section would be further developed in a final version of the comprehensive reference document.

²⁵ Foundation for Information Policy Research, *Signature Directive Consultation Compilation*, 28 October 1998, which provides a compilation of responses made during consultations on the European Union draft directive on electronic signatures, prepared at the request of the European Commission, available at www.fipr.org/publications/sigdirecon.html, accessed on 12 April 2007.

communications. It is important for legislators and policymakers to bear in mind these widespread business practices when considering regulating electronic authentication and signature. Stringent requirements for electronic authentication and signature, in particular the imposition of a particular method or technology, may inadvertently cast doubt as to the validity and enforceability of a significant number of transactions that are entered into every day without the use of any particular kind of authentication or signature. That, in turn, may stimulate parties acting in bad faith to avoid the consequences of obligations they freely assumed by questioning the authenticity of their own electronic communications. It is unrealistic to expect that imposing a certain high level of authentication and signature requirements would eventually lead all parties to actually use them on a daily basis. Recent experience with sophisticated methods, such as digital signatures, has shown that concerns about cost and complexity often limit the practical use of authentication and signature techniques.

C. Electronic identity management*

45. In the electronic world, natural or legal persons may access the services of a number of providers. Every time a person registers with a service provider to access those services, an electronic “identity” is created. Moreover, a single identity may be linked to a number of accounts for each application or platform. The multiplication of identities and of their accounts may hinder their management both for the user and for the service provider. These difficulties could be avoided by having a single electronic identity for each person.

46. The registration with a service provider and the creation of an electronic identity entails the establishment of a mutually trusted relationship between the person and the provider. The creation of a single electronic identity requires gathering together those bilateral relationships into a broader framework where they could be managed jointly, in what is referred to as identity management. Benefits of identity management on the provider side may include security improvements, easier regulatory compliance and greater business agility; on the user side, they may include facilitated access to information.

47. Identity management may be described in the context of two approaches: the traditional user access (log-on) paradigm, based on a smart card and its associated data that a customer uses to log on to a service; and the more innovative service paradigm, based on a system that delivers personalized services to users and their devices.

48. The user access approach to identity management focuses on the administration of user authentication, access rights, access restrictions, account profiles, passwords and other attributes in one or more applications or systems. It aims at facilitating and controlling access to applications and resources while protecting confidential personal and business information from unauthorized users.

49. Under the service paradigm approach, the scope of identity management becomes broader and includes all the resources of the company that are used to deliver online services, such as network equipment, servers, portals, content, applications and products, as well as a user’s credentials, address books, preferences and entitlements. In practice, it could include, for instance, information relating to parental control settings and participation in loyalty programmes.

50. Efforts are under way to expand identity management both at the business and at the Governmental level. However, it should be noted that policy choices in the two scenarios may differ considerably. In fact, the Government approach may be more oriented towards better serving citizens' needs and therefore may be slanted towards interaction with physical persons. On the other hand, commercial applications need to take into account the increasing use of automated machines in business transactions and therefore may adopt features meant to accommodate the specific needs of those machines.

51. Difficulties identified in relation to identity management systems include privacy concerns due to the risks associated with the misuse of unique identifiers. Moreover, issues may arise also with respect to differences in applicable legal regulations, especially in relation to the possibility to delegate authority to act for another. Solutions based on voluntary business cooperation based on a so-called circle of trust, where participants are required to rely on the correctness and accuracy of the information provided to them by other members of the circle, have been suggested. However, this approach may not be fully sufficient to regulate all related matters and might still require the adoption of a legal framework.²⁶ Guidelines have also been developed to provide legal requirements for the compliance of a circle of trusted infrastructures.²⁷

52. With respect to technical interoperability, the International Telecommunication Union has established a Focus Group on Identity Management "to facilitate and advance the development of a generic [identity management] framework and means of discovery of autonomous distributed identities and identity federations and implementations".²⁸

53. Identity management solutions are being provided also in the context of e-government. For instance, in the context of the European Union "i2010: a European Information Society for growth and employment" initiative, a study on identity management in e-government was initiated to facilitate progress towards a coherent approach in electronic identity management in e-government in the European Union based on existing expertise and initiatives in the European Union member States.²⁹

54. The distribution of electronic signature devices, often in the form of smart cards, in the context of e-government initiatives is becoming increasingly common. Nationwide exercises of distribution of smart cards have been launched, among other places, in Belgium³⁰ and in Estonia. As a consequence of those initiatives, a

²⁶ See *Modinis Study on Identity Management in eGovernment: Identity Management Issue Report* (European Commission, Directorate General Information Society and Media, June 2006), pp. 9-12, available at https://www.cosic.esat.kuleuven.be/modinis-idm/twiki/pub/Main/ProjectDocs/modinis.D3.9_Identity_Management_Issue_Interim_Report_II1.pdf.

²⁷ The Liberty Alliance Project (see www.projectliberty.org) is an alliance of more than 150 companies, non-profit and Government organizations from around the globe. The consortium is committed to developing an open standard for federated network identity that supports all current and emerging network devices. Federated identity offers businesses, Governments, employees and consumers a more convenient and secure way to control identity information in today's digital economy and is a key component in driving the use of e-commerce and personalized data services, as well as web-based services. Membership is open to all commercial and non-commercial organizations.

²⁸ See www.itu.int/ITU-T/studygroups/com17/fgidm/index.html.

²⁹ See <https://www.cosic.esat.kuleuven.be/modinis-idm/twiki/bin/view.cgi>.

³⁰ See <http://eid.belgium.be/en/navigation/12000/index.html>.

very large number of citizens are receiving devices with, inter alia, secure electronic signature capabilities at low cost. While the primary goal of those initiatives may not be commercial, such devices may equally be used in the commercial world. The convergence of the two domains of application is increasingly acknowledged.³¹

³¹ See, for instance, *2006 Korea Internet White Paper* (Seoul, National Internet Development Agency of Korea, 2006), p. 81, with reference to the dual use in e-government and e-commerce applications of the Electronic Signature Act of the Republic of Korea, available at www.ecommerce.or.kr/activities/documents_view.asp?bNo=642&Page=1.

A/CN.9/630/Add.2 [Original: English]

**Comprehensive reference document on elements required to establish a
favourable legal framework for electronic commerce: sample chapter on
international use of electronic authentication and signature methods**

ADDENDUM

The annex to the present note contains part of a sample chapter (part one, chap. II, sects. A and B) of a comprehensive reference document dealing with legal issues related to the international use of electronic authentication and signature methods.

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Part One

Electronic signature and authentication methods

[...]

II. Legal treatment of electronic authentication and signatures

1. Creating trust in electronic commerce is of great importance for its development. Special rules may be needed to increase certainty and security in its use. Such rules may be provided in a variety of legislative texts: international legal instruments (treaties and conventions); transnational model laws; national legislation (often based on model laws); self-regulatory instruments;¹ or contractual agreements.²

2. A significant volume of electronic commercial transactions is performed in closed networks, that is, groups with a limited number of participants accessible only to previously authorized persons or companies. Closed networks support the operation of a single entity or an existing closed user group, such as financial institutions participating in the inter-bank payment system, securities and commodities exchanges, or an association of airlines and travel agents. In these cases, participation in the network is typically restricted to institutions and companies previously admitted to the group. Most of these networks have been in place for several decades, use sophisticated technology and have acquired a high level of expertise in the functioning of the system. The rapid growth of electronic commerce in the last decade has led to the development of other network models, such as supply chains or trade platforms.

3. Although these new groups were originally structured around direct computer-to-computer connections as were most of the closed networks already in existence at that time, there is an increasing trend towards using publicly accessible means, such as the Internet, as a common connection facility. Even under these more recent models, a closed network retains its exclusive character. Typically, closed networks operate under previously agreed contractual standards, agreements, procedures and rules known by various names such as “system rules”, “operation rules” or “trading partner agreements” that are designed to provide and guarantee the necessary operational functionality, reliability and security for the members of the group. These rules and agreements often deal with matters such as recognition of the legal value of electronic communications, time and place of dispatch or receipt of data messages, security procedures for gaining access to the network and authentication

¹ See, for example, Economic Commission for Europe, United Nations Centre for Trade Facilitation and Electronic Business, recommendation No. 32, entitled “E-commerce self-regulatory instruments (codes of conduct)” (ECE/TRADE/277), available at www.unece.org/cefact/recommendations/rec_index.htm, accessed on 28 March 2007.

² Many initiatives at the national and international levels aim at developing model contracts. See, for example, Economic Commission for Europe, Working Party on the Facilitation of International Trade Procedures, recommendation No. 26, entitled “The commercial use of interchange agreements for electronic data interchange” (TRADE/WP.4/R.1133/Rev.1); and United Nations Centre for Trade Facilitation and Electronic Business, recommendation No. 31, entitled “Electronic commerce agreement” (ECE/TRADE/257), both available at www.unece.org/cefact/recommendations/rec_index.htm, accessed on 28 March 2007.

or signature methods to be used by the parties.³ Within the limits of the contractual freedom under applicable law, such rules and agreements are usually self-enforcing.

4. However in the absence of contractual rules, or to the extent that applicable law may limit their enforceability, the legal value of electronic authentication and signature methods used by the parties will be determined by the applicable rules of law, in the form of default or mandatory rules. The various options used in different jurisdictions to develop a legal framework for electronic signatures and authentication are discussed in the present chapter.

A. Technology approach of legislative texts

5. Electronic authentication legislation and regulation has taken many different forms at the international and domestic levels. Three main approaches for dealing with signature and authentication technologies can be identified: (a) the **minimalist approach**; (b) the **technology specific approach**; and (c) the **two-tiered** or **two-pronged approach**.⁴

1. Minimalist approach

6. Some jurisdictions recognize all technologies for electronic signature, following a policy of technological neutrality.⁵ This approach is also called minimalist, since it gives a minimum legal status to all forms of electronic signature. Under the minimalist approach, electronic signatures are considered to be the functional equivalent of handwritten signatures, provided that the technology employed is intended to serve certain specified functions and in addition meets certain technology-neutral reliability requirements.

7. The UNCITRAL Model Law on Electronic Commerce⁶ provides the most widely used set of legislative criteria for establishing a generic functional equivalence between electronic and handwritten signatures. Article 7, paragraph 1, of the Model Law provides:

“(1) Where the law requires a signature of a person, that requirement is met in relation to a data message if:

“(a) a method is used to identify that person and to indicate that person’s approval of the information contained in the data message; and

“(b) that method is as reliable as was appropriate for the purpose for which the data message was generated or communicated, in the light of all the circumstances, including any relevant agreement.”

8. This provision contemplates the two main functions of handwritten signatures: to identify the signatory, and to indicate the signatory’s intent with respect to the signed information. Any technology that can provide these two functions in

³ For a discussion of issues typically covered in trading partner agreements, see Amelia H. Boss, “Electronic data interchange agreements: private contracting toward a global environment”, *Northwestern Journal of International Law and Business*, vol. 13, No. 1 (1992), p. 45.

⁴ Susanna F. Fischer, “Saving Rosencrantz and Guildenstern in a virtual world? A comparative look at recent global electronic signature legislation,” *Journal of Science and Technology Law*, vol. 7, No. 2 (2001), pp. 234 ff.

⁵ For example, Australia and New Zealand.

⁶ See note [...] [United Nations publication, Sales No. E.99.V.4].

electronic form should, according to the Model Law on Electronic Commerce, be regarded as satisfying a legal signature requirement. The Model Law is therefore technologically neutral; that is, it does not depend on or presuppose the use of any particular type of technology and could be applied to the communication and storage of all types of information. Technological neutrality is particularly important in view of speed of technological innovation and helps to ensure that legislation remains capable of accommodating future developments and does not become obsolete too quickly. Accordingly, the Model Law carefully avoids any reference to particular technical methods of transmission or storage of information.

9. This general principle has been incorporated into the laws of many countries. The principle of technological neutrality also allows for future technological developments to be accommodated. Furthermore, this approach gives prominence to the freedom of the parties to choose technology that is appropriate to their needs. The onus is then placed on the parties' ability to determine the level of security that is adequate for their communications. This may avoid excessive technological complexity and its associated costs.⁷

10. Except in Europe, where legislation has been primarily influenced by directives issued by the European Union,⁸ most countries that have legislated in relation to electronic commerce have used the Model Law on Electronic Commerce as their template.⁹ The Model Law has also served as a basis for the domestic

⁷ S. Mason, "Electronic signatures in practice", *Journal of High Technology Law*, vol. VI, No. 2 (2006), p. 153.

⁸ In particular, Directive 1999/93/EC of the European Parliament and of the Council on a Community framework for electronic signatures (see note [...]) [*Official Journal of the European Communities*, L 13]. The Directive on electronic signatures was followed by a more general one, Directive 2000/31/EC of the European Parliament and of the Council of 8 June 2000 on certain legal aspects of information society services, in particular electronic commerce, in the Internal Market (Directive on electronic commerce) (*Official Journal of the European Communities*, L 178, 17 July 2000), dealing with various aspects of the provision of information technology services and some matters of electronic contracting.

⁹ As at January 2007, legislation implementing provisions of the UNCITRAL Model Law on Electronic Commerce had been adopted in at least the following countries: Australia, Electronic Transactions Act 1999; China, Electronic Signatures Law, promulgated in 2004; Colombia, *Ley de comercio electrónico*; Dominican Republic, *Ley sobre comercio electrónico, documentos y firmas digitales* (2002); Ecuador, *Ley de comercio electrónico, firmas electrónicas y mensajes de datos* (2002); France, *Loi 2000-230 portant adaptation du droit de la preuve aux technologies de l'information et relative à la signature électronique* (2000); India, Information Technology Act, 2000; Ireland, Electronic Commerce Act, 2000; Jordan, Electronic Transactions Law, 2001; Mauritius, Electronic Transactions Act 2000; Mexico, *Decreto por el que se reforman y adicionan diversas disposiciones del código civil para el distrito federal en materia federal, del Código federal de procedimientos civiles, del Código de comercio y de la Ley federal de protección al consumidor* (2000); New Zealand, Electronic Transactions Act 2002; Pakistan, Electronic Transactions Ordinance, 2002; Panama, *Ley de firma digital* (2001); Philippines, Electronic Commerce Act (2000); Republic of Korea, Framework Act on Electronic Commerce (2001); Singapore, Electronic Transactions Act (1998); Slovenia, Electronic Commerce and Electronic Signature Act (2000); South Africa, Electronic Communications and Transactions Act (2002); Sri Lanka, Electronic Transactions Act (2006); Thailand, Electronic Transactions Act (2001); Venezuela (Bolivarian Republic of), *Ley sobre mensajes de datos y firmas electrónicas* (2001); and Viet Nam, Law on Electronic Transactions, (2006). The Model Law has also been adopted in the British crown dependencies of the Bailiwick of Guernsey (Electronic Transactions (Guernsey) Law 2000), the Bailiwick of Jersey (Electronic Communications (Jersey) Law 2000) and the Isle of Man (Electronic Transactions Act 2000); in

harmonization of e-commerce legislation in countries organized on a federal basis, such as Canada¹⁰ and the United States of America.¹¹ With very few exceptions,¹² countries enacting the Model Law have preserved its technologically neutral approach and have neither prescribed nor favoured the use of any particular technology. Both the UNCITRAL Model Law on Electronic Signatures,¹³ which was adopted in 2001, and the more recent United Nations Convention on the Use of Electronic Communications in International Contracts¹⁴ (which was adopted by the General Assembly on 23 November 2005 and has been opened for signature since 16 January 2006) follow the same approach, although the UNCITRAL Model Law on Electronic Signatures contains some additional language (see below, paras. [...]-[...]).

11. When legislation adopts the minimalist approach, the issue of whether electronic signature equivalence has been proven normally falls to a judge, arbitrator or public authority to determine, generally by means of the so-called “appropriate reliability test”. Under this test, all types of electronic signature that

the overseas territories of the United Kingdom of Great Britain and Northern Ireland of Bermuda (Electronic Transactions Act 1999), the Cayman Islands (Electronic Transactions Law 2000) and the Turks and Caicos (Electronic Transactions Ordinance 2000); and in Hong Kong Special Administrative Region (SAR) of China (Electronic Transactions Ordinance (2000)). Unless otherwise indicated, references made hereafter to statutory provisions of any of these countries refer to provisions contained in the statutes listed above.

¹⁰ The domestic enactment of the model law in Canada is the Uniform Electronic Commerce Act, adopted by the Uniform Law Conference of Canada in 1999 (available with official commentary at www.chlc.ca/en/poam2/index.cfm?sec=1999&sub=1999ia, accessed on 12 April 2007). The Act has since been enacted in a number of provinces and territories of Canada, including Alberta, British Columbia, Manitoba, New Brunswick, Newfoundland and Labrador, Nova Scotia, Ontario, Prince Edward Island, Saskatchewan and Yukon. The Province of Quebec enacted specific legislation (the Act to Establish a Legal Framework for Information Technology (2001)), which, although being broader in scope and drafted very differently, achieves many of the objectives of the Uniform Electronic Commerce Act and is generally consistent with the UNCITRAL Model Law on Electronic Commerce. Updated information on the enactment of the Uniform Electronic Commerce Act may be found at www.chlc.ca/en/cls/index.cfm?sec=4&sub=4b, accessed on 7 February 2007.

¹¹ In the United States of America, the National Conference of Commissioners on Uniform State Law used the UNCITRAL Model Law on Electronic Commerce as a basis for preparing the Uniform Electronic Transactions Act, which it adopted in 1999 (the text of the Act and the official commentary is available at www.law.upenn.edu/bll/ulc/uecicta/eta1299.htm, accessed on 7 February 2007). The Uniform Electronic Transactions Act has since been enacted in the District of Columbia and in the following 46 states: Alabama, Alaska, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, Florida, Hawaii, Idaho, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Utah, Vermont, Virginia, West Virginia, Wisconsin and Wyoming. Other states are likely to adopt implementing legislation in the near future, including the state of Illinois, which had already enacted the UNCITRAL Model Law through the Electronic Commerce Security Act (1998). Updated information on the enactment of the Uniform Electronic Transactions Act may be found at www.nccusl.org/nccusl/uniformact_factsheets/uniformacts-fs-ueta.asp, accessed on 7 February 2007.

¹² Colombia, Dominican Republic, Ecuador, India, Mauritius, Panama and South Africa.

¹³ See note [...] [United Nations publication, Sales No. E.02.V.8].

¹⁴ See note [...] [General Assembly resolution, 60/21, annex].

satisfy the test are considered valid; hence, the test embodies the principle of technological neutrality.

12. A wide array of legal, technical and commercial factors may be taken into account in determining whether, under the circumstances, a particular authentication method offers an appropriate level of reliability, including: (a) the sophistication of the equipment used by each of the parties; (b) the nature of their trade activity; (c) the frequency with which commercial transactions take place between the parties; (d) the nature and size of the transaction; (e) the function of signature requirements in a given statutory and regulatory environment; (f) the capability of communication systems; (g) compliance with authentication procedures set forth by intermediaries; (h) the range of authentication procedures made available by any intermediary; (i) compliance with trade customs and practice; (j) the existence of insurance coverage mechanisms against unauthorized messages; (k) the importance and the value of the information contained in the data message; (l) the availability of alternative methods of identification and the cost of implementation; and (m) the degree of acceptance or non-acceptance of the method of identification in the relevant industry or field both at the time the method was agreed upon and the time when the data message was communicated.

2. Technology-specific approach

13. The concern to promote media neutrality raises other important issues. The impossibility of guaranteeing absolute security against fraud and transmission error is not limited to the world of electronic commerce and applies to the world of paper documents as well. When formulating rules for electronic commerce, legislators are often inclined to aim at the highest level of security offered by existing technology.¹⁵ The practical need for applying stringent security measures to avoid unauthorized access to data, ensure the integrity of communications and protect computer and information systems cannot be questioned. However, from the perspective of private business law, it may be more appropriate to graduate security requirements in steps similar to the degrees of legal security encountered in the paper world. In the paper world, businessmen are in most cases free to choose among a wide range of methods to achieve integrity and authenticity of communications (for example, the different levels of handwritten signature seen in documents of simple contracts and notarized acts). Under a technology-specific approach, regulations would mandate a specific technology to fulfil the legal requirements for the validity of an electronic signature. This is the case, for instance, where the law, aiming at a higher level of security, demands PKI-based

¹⁵ One of the earliest examples was the Utah Digital Signature Act, which was adopted in 1995, but was repealed effective 1 May 2006 by State Bill 20, available at www.le.state.ut.us/~2006/htmldoc/sbillhtm/sb0020.htm, accessed on 28 March 2007. The technology bias of the Utah Act can also be observed in a number of countries where the law only recognizes digital signatures created within a public key infrastructure (PKI) as a valid means of electronic authentication, which is the case, for example, under the laws of Argentina, Ley de firma digital (2001) and Decreto No. 2628/2002 (Reglamentación de la Ley de firma digital); Estonia, Digital Signatures Act (2000); Germany, Digital Signature Act, enacted as article 3 of the Information and Communication Services Act of 13 June 1997; India, Information Technology Act 2000; Israel, Electronic Signature Law (2001); Japan, Law concerning Electronic Signatures and Certification Services (2001); Lithuania, Law on Electronic Signatures (2000); Malaysia, Digital Signature Act 1997; Poland, Act on Electronic Signature (2001); and Russian Federation, Law on Electronic Digital Signature (2002).

applications. Since it prescribes the use of a specific technology, it is also called the “prescriptive” approach.

14. The disadvantages of the technology-specific approach are that, in favouring specific types of electronic signature, it “risks excluding other possibly superior technologies from entering and competing in the marketplace”.¹⁶ Rather than facilitating the growth of electronic commerce and the use of electronic authentication techniques, such an approach may have an opposite effect. Technology specific legislation risks fixing requirements before a particular technology matures.¹⁷ The legislation may then either prevent later positive developments in the technology or become quickly outdated as a result of later developments. A further point is that not all applications may require a security level comparable with that provided by certain specified techniques, such as digital signatures. It may also happen that speed and ease of communication or other considerations may be more important for the parties than ensuring the integrity of electronic information through any particular process. Requiring the use of an overly secure means of authentication could result in wasted costs and efforts, which may hinder the diffusion of electronic commerce.

15. Technology-specific legislation typically favours the use of digital signatures within a PKI. The way in which PKIs are structured, in turn, varies from country to country according to the level of Government intervention. Here, too, three main models can be identified:

(a) **Self-regulation.** Under this model, the authentication arena is left wide open. While the Government may establish one or more authentication schemes within its own departments and related organizations, the private sector is free to set up authentication schemes, commercial or otherwise, as it sees fit. There is no mandatory high-level authentication authority and authentication service providers are responsible for ensuring interoperability with other providers, domestically and internationally, depending on the objectives of establishing the authentication scheme. No licensing or technology approvals of authentication service providers are required (with the possible exception of consumer protection regulations);¹⁸

(b) **Limited Government interference.** The Government might decide to establish a voluntary or mandatory high-level authentication authority. In this case, authentication service providers may find it necessary to interoperate with the high-level authentication authority to have their tokens of authentication (or other authenticators) accepted outside their own systems. In this case, the technical and management specifications of the authentication service providers must be published as quickly as possible so that both Government departments and the

¹⁶ Stewart Baker and Matthew Yeo, in collaboration with the secretariat of the International Telecommunication Union, “Background and issues concerning authentication and the ITU”, briefing paper presented to the Experts Meeting on Electronic Signatures and Certification Authorities: Issues for Telecommunications, Geneva, 9 and 10 December 1999, Document No. 2, available at www.itu.int/osg/spu/ni/esca/meetingdec9-101999/briefingpaper.html, accessed on 12 April 2007.

¹⁷ However, in view of the fact that PKI is today fairly mature and established, some of these concerns may no longer apply with the same force.

¹⁸ Asia-Pacific Economic Cooperation, *Assessment Report on Paperless Trading of APEC Economies* (Beijing, APEC secretariat, 2005), pp. 63 and 64, where the United States is cited as an example of the application of this model.

private sector may plan accordingly. Licensing and technology approvals for each authentication service provider could be required;¹⁹

(c) **Government-led process.** The Government may decide to establish an exclusive central authentication service provider. Special purpose authentication service providers may also be established with Government approval.²⁰ Identity management systems (see paras. [...] above) represent another way in which Governments may indirectly lead the process of digital signature. Some Governments have already launched programmes for issuing to their citizens machine-readable identity documents (“electronic identifications”) equipped with digital signature functionalities.

3. Two-tiered or two-pronged approach

16. In this approach, the legislation sets a low threshold of requirements for electronic authentication methods to receive a certain minimum legal status and assigns greater legal effect to certain electronic authentication methods (referred to variously as secure, advanced or enhanced electronic signatures, or qualified certificates).²¹ At the basic level, legislation adopting a two-tiered system generally grants electronic signatures functional-equivalence status with handwritten signatures, based on technologically neutral criteria. Higher-level signatures, to which certain rebuttable presumptions apply, are required to comply with specific requirements that may relate to a particular technology. Currently, legislation of this type usually defines such secure signatures in terms of PKI technology.

17. This approach is typically chosen in jurisdictions that consider it important to address certain technological requirements in their legislation, but wish, at the same time, to leave room for technological developments. It can provide a balance between flexibility and certainty in relation to electronic signatures, by leaving it to the parties to decide, as a commercial judgement, whether the cost and inconvenience of using a more secure method is suitable to their needs. These texts also provide guidance as to the criteria for the recognition of electronic signatures in the context of a certification authority model. It is generally possible to combine the two-tiered approach with any type of certification model (whether self-regulated, voluntary accreditation or a Government-led scheme), in much the same way as might be done under the technology-specific approach (see above, paras. [...] above). Thus, while some rules may be flexible enough to accommodate different electronic signature certification models, some systems would only recognize licensed certification services providers as possible issuers of “secure” or “qualified” certificates.

18. The first jurisdictions to have passed legislation adopting the two-tiered approach include Singapore²² and the European Union.²³ They were followed by a

¹⁹ Ibid., where Singapore is cited as an example.

²⁰ Ibid., where China and Malaysia are cited as examples.

²¹ Aalberts and van der Hof, *Digital Signature Blindness* ... (see note [...]), para. 3.2.2.

²² Section 8 of the Electronic Transactions Act of Singapore admits any form of electronic signature, but only secure electronic signatures that meet the requirements of section 17 of the Act (i.e. those which are “(a) unique to the person using it; (b) capable of identifying such person; (c) created in a manner or using a means under the sole control of the person using it; and (d) linked to the electronic record to which it relates in a manner that if the record was changed the electronic signature would be invalidated”) enjoy the presumptions listed in section 18 (inter alia, that the signature “is of the person to whom it correlates” and that the

number of others.²⁴ The UNCITRAL Model Law on Electronic Signatures allows an enacting State to set up a two-tiered system through regulations, even though it does not actively promote it.²⁵

19. Regarding the second tier, it was proposed that countries should not require the use of second-tier signatures for form requirements relating to international commercial transactions and that “secure” electronic signatures should be limited to areas of the law that do not have a significant impact on international trade (e.g. trusts, family law, real property transactions, etc.).²⁶ Moreover, it was suggested that two-tier laws should explicitly give effect to contractual agreements concerning the use and recognition of electronic signatures, so as to ensure that global contract-based authentication models do not run afoul of national legal requirements.

B. Evidentiary value of electronic signature and authentication methods

20. One of the main objectives of the UNCITRAL Model Law on Electronic Commerce and the UNCITRAL Model Law on Electronic Signatures was to pre-empt disharmony and possible over-regulation by offering general criteria to establish the functional equivalence between electronic and paper-based signature and authentication methods. Although the UNCITRAL Model Law on Electronic

signature “was affixed by that person with the intention of signing or approving the electronic record”). Digital signatures supported by a trustworthy certificate that complies with the provisions of section 20 of the Act are automatically considered to be “secure electronic signatures” for the purposes of the Act.

²³ Like the Electronic Transactions Act of Singapore, the European Union Directive on electronic signatures (see note [...]), distinguishes between an “electronic signature” (defined in art. 2, para. 1, as “data in electronic form which are attached to or logically associated with other electronic data and which serve as a method of authentication”) and an “advanced electronic signature” (defined in art. 2, para. 2, as an electronic signature that meets the following requirements: “(a) it is uniquely linked to the signatory; (b) it is capable of identifying the signatory; (c) it is created using means that the signatory can maintain under his sole control; and (d) it is linked to the data to which it relates in such a manner that any subsequent change of the data is detectable”). The Directive, in article 5, paragraph 2, mandates the States members of the European Union to ensure that an electronic signature “is not denied legal effectiveness and admissibility as evidence in legal proceedings solely on the grounds” that it is “in electronic form, or not based upon a qualified certificate, or not based upon a qualified certificate issued by an accredited certification-service-provider, or not created by a secure signature-creation device.” However only advanced electronic signatures “which are based on a qualified certificate and which are created by a secure-signature-creation device” are declared to “(a) satisfy the legal requirements of a signature in relation to data in electronic form in the same manner as a handwritten signature satisfies those requirements in relation to paper-based data; and (b) are admissible as evidence in legal proceedings.” (see art. 5, para. 1, of the Directive).

²⁴ For example, Mauritius and Pakistan. For details of the respective statutes, see note [9] above.

²⁵ UNCITRAL Model Law on Electronic Signatures (see note [...]), article 6, paragraph 3, provides that an electronic signature is considered to be reliable if (a) the signature creation data are, within the context in which they are used, linked to the signatory and to no other person; (b) they were, at the time of signing, under the control of the signatory and of no other person; (c) any alteration to the electronic signature, made after the time of signing, is detectable; and (d) any alteration made to that information after the time of signing is detectable where the legal requirement for a signature is intended to provide assurance as to the integrity of the information.

²⁶ Baker and Yeo, “Background and issues concerning authentication...” (see note [16]).

Commerce has found widespread acceptance, and an increasing number of States have used it as a basis for their e-commerce legislation, it cannot yet be assumed that the principles of the Model Law have achieved universal application. The attitude taken by various jurisdictions in relation to electronic signatures and authentication typically reflects the general approach of the jurisdiction to writing requirements and the evidentiary value of electronic records.

1. “Authentication” and general attribution of electronic records

21. The use of electronic methods of authentication involves two aspects that are relevant for the present discussion. The first aspect relates to the general issue of attribution of a message to its purported originator. The second relates to the appropriateness of the identification method used by the parties for the purpose of meeting specific form requirements, in particular legal signature requirements. Also relevant are legal notions that imply the existence of a handwritten signature, such as is the case for the notion of a “document” in some legal systems. Even though these two aspects may often be combined or, depending on the circumstances, may not be entirely distinguishable one from another, an attempt to analyse them separately may be useful, as it appears that courts tend to reach different conclusions according to the function being attached to the authentication method.

22. The Model Law on Electronic Commerce deals with attribution of data messages in its article 13. That provision has its origin in article 5 of the UNCITRAL Model Law on International Credit Transfers,²⁷ which defines the obligations of the sender of a payment order. Article 13 of the Model Law on Electronic Commerce is intended to apply where there is a question as to whether an electronic communication was really sent by the person who is indicated as being the originator. In the case of a paper-based communication, the problem would arise as the result of an alleged forged signature of the purported originator. In an electronic environment, an unauthorized person may have sent the message, but the authentication by code, encryption or similar means would be accurate. The purpose of article 13 is not to attribute authorship of a data message or to establish the identity of the parties. Rather, it deals with the attribution of data messages, by establishing the conditions under which a party may rely on the assumption that a data message was actually from the purported originator.

23. Article 13, paragraph 1, of the Model Law on Electronic Commerce recalls the principle that an originator is bound by a data message if it has effectively sent that message. Paragraph 2 refers to a situation where the message was sent by a person other than the originator who had the authority to act on behalf of the originator. Paragraph 3 deals with two kinds of situation in which the addressee could rely on a data message as being that of the originator: first, situations in which the addressee properly applied an authentication procedure previously agreed to by the originator; and second, situations in which the data message resulted from the actions of a person who, by virtue of his or her relationship with the originator, had access to the originator’s authentication procedures.

24. A number of countries have adopted the rule in article 13 of the Model Law on Electronic Commerce, including the presumption of attribution established in paragraph 3 of that article.²⁸ Some countries expressly refer to the use of codes,

²⁷ United Nations publication, Sales No. E.99.V.11, available at www.uncitral.org/pdf/english/texts/payments/transfers/ml-credittrans.pdf.

²⁸ Colombia (art. 17); Ecuador (art. 10); Jordan (art. 15); Mauritius (sect. 12, subsect. 2);

passwords or other means of identification as factors that create a presumption of authorship.²⁹ There are also more general versions of article 13, in which the presumption created by proper verification through a previously agreed procedure is rephrased as an indication of elements that may be used for attribution purposes.³⁰

25. However, other countries have adopted only the general rules in article 13, namely that a data message is that of the originator if it was sent by the originator him or herself, or by a person acting on the originator's behalf, or by a system programmed by or on behalf of the originator to operate automatically.³¹ In addition, several countries that have implemented the Model Law on Electronic Commerce have not included any specific provision based on article 13.³² The assumption in those countries was that no specific rules were needed and that attribution was better left to ordinary methods of proof, in the same way as attribution of documents on paper: "The person who wishes to rely on any signature takes the risk that the signature is invalid, and this rule does not change for an electronic signature."³³

26. Other countries, however, have preferred to take the provisions of the Model Law on Electronic Commerce on attribution separately from provisions on electronic signatures. This approach is based on the understanding that attribution in a documentary context serves the primary purpose of providing a basis for reasonable reliance, and may include broader means than those more narrowly used for identifying individuals. Some laws, such as the United States Uniform Electronic Transactions Act, emphasize this principle by stating, for example, that "an electronic record or electronic signature is attributable to a person if it was the act of the person", which "may be shown in any manner, including a showing of the efficacy of any security procedure applied to determine the person to which the electronic record or electronic signature was attributable."³⁴ Such a general rule on

Philippines (sect. 18, para. 3); Republic of Korea (art. 7, para. 2); Singapore (sect. 13, subsect. 3); Thailand (sect. 16); and Venezuela (Bolivarian Republic of) (art. 9). The same rules are also contained in the laws of the British crown dependency of Jersey (art. 8) and the British overseas territories of Bermuda (sect. 16, para. 2) and Turks and Caicos (sect. 14). For details of the respective statutes, see note [9] above.

²⁹ Mexico (see note [9] above), art. 90, para. 1.

³⁰ For example, the Uniform Electronic Transactions Act of the United States (see note [10]) provides in section 9, subsection (a), that an electronic record or electronic signature "is attributable to a person if it was the act of the person. The act of the person may be shown in any manner, including a showing of the efficacy of any security procedure applied to determine the person to which the electronic record or electronic signature was attributable". Section 9, subsection (b), provides further that the effect of an electronic record or electronic signature attributed to a person under subsection (a) "is determined from the context and surrounding circumstances at the time of its creation, execution, or adoption, including the parties' agreement, if any, and otherwise as provided by law".

³¹ Australia (sect. 15, para. 1); essentially in the same manner, India (sect. 11); Pakistan (sect. 13, subsect. 2); Slovenia (art. 5); the British crown dependency of the Isle of Man (sect. 2); and Hong Kong SAR of China (sect. 18). For details of the respective statutes, see note [9] above.

³² For example, Canada, France, Ireland, New Zealand and South Africa.

³³ Canada, Uniform Electronic Commerce Act (with official commentary) (see note [10]), commentary to section 10.

³⁴ United States, Uniform Electronic Transactions Act (1999) (see note [11]), section 9. Paragraph 1 of the official comments to section 9 offer the following examples where both the electronic record and electronic signature would be attributable to a person: a person "types his/her name as part of an e-mail purchase order"; a "person's employee, pursuant to authority, types the person's name as part of an e-mail purchase order"; or a "person's computer, programmed to order goods upon receipt of inventory information within particular parameters,

attribution does not affect the use of a signature as a device for attributing a record to a person, but is based on the recognition that “a signature is not the only method for attribution.”³⁵ According to the commentary on the United States Act, therefore:

“4. Certain information may be present in an electronic environment that does not appear to attribute but which clearly links a person to a particular record. Numerical codes, personal identification numbers, public and private key combinations all serve to establish the party to whom an electronic record should be attributed. Of course security procedures will be another piece of evidence available to establish attribution.

“The inclusion of a specific reference to security procedures as a means of proving attribution is salutary because of the unique importance of security procedures in the electronic environment. In certain processes, a technical and technological security procedure may be the best way to convince a trier of fact that a particular electronic record or signature was that of a particular person. In certain circumstances, the use of a security procedure to establish that the record and related signature came from the person’s business might be necessary to overcome a claim that a hacker intervened. The reference to security procedures is not intended to suggest that other forms of proof of attribution should be accorded less persuasive effect. It is also important to recall that the particular strength of a given procedure does not affect the procedure’s status as a security procedure, but only affects the weight to be accorded the evidence of the security procedure as tending to establish attribution.”³⁶

27. It is also important to bear in mind that a presumption of attribution would not of itself displace the application of rules of law on signatures, where a signature is needed for the validity or proof of an act. Once it is established that a record or signature is attributable to a particular party, “the effect of a record or signature must be determined in light of the context and surrounding circumstances, including the parties’ agreement, if any” and of “other legal requirements considered in light of the context”.³⁷

28. Against the background of this flexible understanding of attribution, the courts in the United States seem to have taken a liberal approach to the admissibility of electronic records, including e-mail, as evidence in civil proceedings.³⁸ Courts in the

issues a purchase order which includes the person’s name, or other identifying information, as part of the order”.

³⁵ Ibid. Paragraph 3 of the official comments to section 9 states: “The use of facsimile transmissions provides a number of examples of attribution using information other than a signature. A facsimile may be attributed to a person because of the information printed across the top of the page that indicates the machine from which it was sent. Similarly, the transmission may contain a letterhead that identifies the sender. Some cases have held that the letterhead actually constituted a signature because it was a symbol adopted by the sender with intent to authenticate the facsimile. However, the signature determination resulted from the necessary finding of intention in that case. Other cases have found facsimile letterheads NOT to be signatures because the requisite intention was not present. The critical point is that with or without a signature, information within the electronic record may well suffice to provide the facts resulting in attribution of an electronic record to a particular party.”

³⁶ Ibid., official comments on section 9.

³⁷ Ibid., paragraph 6 of the official comments on section 9.

³⁸ *Commonwealth Aluminum Corporation v. Stanley Metal Associates*, United States District Court for the Western District of Kentucky, 9 August 2001, Federal Supplement, 2nd series, vol. 186,

United States have dismissed arguments that e-mail messages were inadmissible as evidence because they were unauthenticated and parole evidence.³⁹ The courts have found instead that e-mails obtained from the plaintiff during the discovery process were self-authenticating, since “the production of documents during discovery from the parties’ own files is sufficient to justify a finding of self-authentication”.⁴⁰ The courts tend to take into account all available evidence and do not reject electronic records as being prima facie inadmissible.

29. In countries that have not adopted the Model Law on Electronic Commerce, there seem to be no specific legislative provisions dealing with attribution in an analogous fashion. In those countries, attribution is typically a function of the legal recognition of electronic signatures and the presumptions attached to records authenticated with particular types of electronic signature. Concerns about the risk of manipulation in electronic records have, for instance, led courts in some of those countries to dismiss the value of e-mails as evidence in court proceedings, on the grounds that e-mails do not offer adequate guarantees of integrity.⁴¹ Further examples of a more restrictive approach to the evidentiary value of electronic records and attribution can be found in recent cases involving Internet auctions, in which courts have applied a high standard for attribution of data messages. Those cases have typically involved suits for breach of contract on the grounds of lack of payment for goods allegedly purchased in Internet auctions. Claimants maintained that the defendants were the buyer, as the highest bid for the goods had been authenticated with the defendant’s password and had been sent from the defendant’s e-mail address. The courts have found that those elements were not sufficient to firmly conclude that it was in fact the defendant who had participated in the auction and submitted the winning bid for the goods. The courts have used various arguments to justify that position. For example, passwords were not reliable because anyone who knew the defendant’s password could have used its e-mail address from anywhere and participated in the auction using the defendant’s name,⁴² a risk that some courts estimated as “very high”, on the basis of expert evidence regarding security threats to Internet communications networks, in particular through the use of “Trojan horses” capable of “stealing” a person’s password.⁴³ The risk of unauthorized use of a person’s identification device (password) should be borne by

p. 770; and *Central Illinois Light Company (CILCO) v. Consolidation Coal Company (Consol)*, United States District Court for the Central District of Illinois, 30 December 2002, Federal Supplement, 2nd series, vol. 235, p. 916.

³⁹ *Sea-Land Service, Inc. v. Lozen International, LLC*, United States Court of Appeals for the Ninth Circuit, 3 April 2002, Federal Reporter, 3rd series, vol. 285, p. 808.

⁴⁰ *Superhighway Consulting, Inc. v. Techwave, Inc.*, United States District Court for the Northern District of Illinois, Eastern Division, 16 November 1999, U.S. Dist. LEXIS 17910.

⁴¹ Germany, Amtsgericht (District Court) Bonn, Case No. 3 C 193/01, 25 October 2001, *JurPC Internet-Zeitschrift für Rechtsinformatik und Informationsrecht*, JurPC Web-Dok. No. 332/2002, available at www.jurpc.de/rechtspr/20020332.htm, accessed on 11 September 2003.

⁴² Germany, Amtsgericht (District Court) Erfurt, Case No. 28 C 2354/01, 14 September 2001, *JurPC Internet-Zeitschrift für Rechtsinformatik und Informationsrecht*, JurPC Web-Dok. No. 71/2002, available at www.jurpc.de/rechtspr/20020071.htm, accessed on 25 August 2003; see also Landesgericht (Land Court) Bonn, Case No. 2 O 472/03, 19 December 2003, *JurPC, Internet-Zeitschrift für Rechtsinformatik und Informationsrecht*, JurPC Web-Dok. No. 74/2004, available at www.jurpc.de/rechtspr/20040074.htm, accessed on 2 February 2007.

⁴³ Germany, Landesgericht (Land Court) Konstanz, Case No. 2 O 141/01 A, 19 April 2002, *JurPC Internet-Zeitschrift für Rechtsinformatik und Informationsrecht*, JurPC Web-Dok. No. 291/2002, available at www.jurpc.de/rechtspr/20020291.htm, accessed on 25 August 2003.

the party that offered goods or services through a particular medium, as there was no legal presumption that messages sent through an Internet website with recourse to a person's access password to such website were attributable to that person.⁴⁴ Such a presumption might conceivably be attached to an "advanced electronic signature", as defined in law, but the holder of a simple "password" should not bear the risk of it being misused by unauthorized persons.⁴⁵

2. Ability to meet legal signature requirements

30. In some countries, the courts have been inclined to interpret signature requirements liberally. As previously indicated (see introduction, paras. [...]–[...]), this has been typically the case in some common law jurisdictions in connection with statute of frauds requirements that certain transactions must be in writing and bear a signature in order to be valid. Courts in the United States have also been receptive to legislative recognition of electronic signatures, admitting their use in situations not expressly contemplated in the enabling statute, such as the issue of judicial warrants.⁴⁶ More importantly for a contractual context, the courts have also assessed the adequacy of the authentication in the light of the dealings between the parties, rather than using a strict standard for all situations. Thus, where the parties had regularly used e-mail in their negotiations, the courts have found that the originator's typed name in an e-mail satisfied statutory signature requirements.⁴⁷ A person's "deliberate choice to type his name at the conclusion of all e-mails" has been considered to be valid authentication.⁴⁸ The readiness of the United States courts to accept that e-mails and names typed therein are capable of satisfying writing requirements⁴⁹ follows a liberal interpretation of the notion of "signature", which is understood as encompassing "any symbol executed or adopted by a party with present intention to authenticate a writing" so that, in some instances, "a typed name or letterhead on a document is sufficient to satisfy the signature requirement".⁵⁰ Where the parties do not deny having written or received communications by e-mail, statutory signature requirements would be met, since courts have "long recognized that a binding signature may take the form of any

⁴⁴ Germany, Landesgericht (Land Court) Bonn, Case No. 2 O 450/00, 7 August 2001, *JurPC Internet-Zeitschrift für Rechtsinformatik und Informationsrecht*, JurPC Web-Dok. No. 136/2002, available at www.jurpc.de/rechtspr/20020136.htm, accessed on 25 August 2003.

⁴⁵ Germany, Oberlandesgericht (Court of Appeal) Köln, Case No. 19 U 16/02, 6 September 2002, *JurPC Internet-Zeitschrift für Rechtsinformatik und Informationsrecht*, JurPC Web-Dok. No. 364/2002, available at www.jurpc.de/rechtspr/20020364.htm, accessed on 25 August 2003.

⁴⁶ *Department of Agriculture and Consumer Services v. Haire*, Fourth District Court of Appeal of Florida, Case Nos. 4D02-2584 and 4D02-3315, 15 January 2003.

⁴⁷ *Cloud Corporation v. Hasbro, Inc.*, United States Court of Appeals for the Seventh Circuit, 26 December 2002, Federal Reporter, 3rd series, vol. 314, p. 296.

⁴⁸ *Jonathan P. Shattuck v. David K. Klotzbach*, Superior Court of Massachusetts, 11 December 2001, 2001 Mass. Super. LEXIS 642.

⁴⁹ *Central Illinois Light Company v. Consolidation Coal Company*, United States District Court for the Central District of Illinois, Peoria Division, 30 December 2002, Federal Supplement, 2nd Series, vol. 235, p. 916.

⁵⁰ *Ibid.*, p. 919: "Internal documents, invoices and e-mails can be used to satisfy the Illinois [Uniform Commercial Code] statute of frauds". In the concrete case, however, the court found that the alleged contract failed to satisfy the statute of frauds, not because the e-mails as such could not validly record the terms of a contract, but because there was no indication that the authors of the e-mails and the persons mentioned therein were employees of the defendant.

mark or designation thought proper by the party to be bound”, provided that the author “intends to bind himself”.⁵¹

31. Courts in the United Kingdom of Great Britain and Northern Ireland have taken a similar approach, generally considering the form of a signature to be less relevant than the function it serves. Thus, courts would consider the fitness of the medium both to attribute a record to a particular person, and to indicate the person’s intention with respect to the record. E-mails may therefore constitute “documents”, and names typed on the e-mails may be “signatures”.⁵² Some courts have declared that they “have no doubt that if a party creates and sends an electronically created document then he will be treated as having signed it to the same extent that he would in law be treated as having signed a hard copy of the same document” and that “[t]he fact that the document is created electronically as opposed to as a hard copy can make no difference.”⁵³ On occasion, courts have rejected arguments that e-mails constituted signed contracts for the purposes of the statute of frauds, mainly because the intent to be bound by the signature was lacking. There seems to be no precedent, however, where courts would have denied a priori the ability of e-mails and names typed therein to meet statutory writing and signature requirements. In some cases, it was found that the requirements of the statute of frauds were not met because the e-mails in question only reflected ongoing negotiations and not a final agreement, for instance because during the negotiations one of the parties had contemplated that a binding contract would be entered into once a “deal memo” had been signed, and not before.⁵⁴ In other cases courts have suggested that they might have been inclined to admit as a signature the originator’s “name or initials” at “the end of the e-mail” or “anywhere else in the body of the e-mail”, but held that the “automatic insertion of a person’s e-mail address after the document has been transmitted by either the sending and/or receiving [Internet service provider]” was not “intended for a signature”.⁵⁵ Although British courts seem to interpret the writing requirements of the statute of frauds more strictly than their United States counterparts, they are generally inclined to admit the use of any type of electronic signature or authentication method, even outside any specific statutory authorization, as long as the method in question serves the same functions as a handwritten signature.⁵⁶

⁵¹ *Roger Edwards, LLC v. Fiddes & Son, Ltd.*, United States District Court for the District of Maine, 14 February 2003, Federal Supplement, 2nd Series, vol. 245, p. 251.

⁵² *Hall v. Cognos Limited* (Hull Industrial Tribunal, Case No. 1803325/97) (unreported).

⁵³ *Mehta v. J. Pereira Fernandes S.A.* [2006] EWHC 813 (Ch), (United Kingdom, England and Wales High Court, Chancery Division), [2006] 2 Lloyd’s Rep 244 (United Kingdom, England and Wales, Lloyd’s List Law Reports).

⁵⁴ *Pretty Pictures Sarl v. Quixote Films Ltd.*, 30 January 2003 ([2003] EWHC 311 (QB), (United Kingdom, England and Wales High Court, Law Reports Queen’s Bench, [2003] All ER (D) 303 (January)) (United Kingdom, All England Direct Law Reports (Digests)).

⁵⁵ *Mehta v. J. Pereira Fernandes S.A.* (see note [55]).

⁵⁶ *Mehta v. J. Pereira Fernandes S.A.* (see note [55]), No. 25: “It is noteworthy that the Law Commission’s view in relation to [the European Union Directive on electronic commerce (2000/31/EC)] is that no significant changes are necessary in relation to statutes that require signatures because whether those requirements have been satisfied can be tested in a functional way by asking whether the conduct of the would-be signatory indicates an authenticating intention to a reasonable person. ... Thus, as I have already said, if a party or a party’s agent sending an e-mail types his or her or his or her principal’s name to the extent required or permitted by existing case law in the body of an e-mail, then in my view that would be a sufficient signature for the purposes of [the statute of frauds]”.

32. Courts in civil law jurisdictions tend generally to follow a more restrictive approach, arguably because for many of those countries the notion of “document” ordinarily implies the use of some form of authentication, thus becoming hardly dissociable from a “signature”. Courts in France, for instance, had been reluctant to accept electronic means of identification as equivalent to handwritten signatures until the adoption of legislation expressly recognizing the validity of electronic signatures.⁵⁷ A slightly more liberal line is taken by decisions that accept the electronic filing of administrative complaints for the purpose of meeting a statutory deadline, at least as long as they are subsequently confirmed by regular correspondence.⁵⁸

33. In contrast to their restrictive approach to the attribution of data messages in the formation of contracts, German courts seem to have been liberal in the acceptance of identification methods as equivalent to handwritten signatures in court proceedings. The debate in Germany has evolved around the increasing use of scanned images of legal counsel’s signature to authenticate computer facsimiles containing statements of appeals transmitted directly from a computer station via modem to a court’s facsimile machine. In earlier cases, courts of appeal⁵⁹ and the Federal Court (*Bundesgerichtshof*)⁶⁰ had held that a scanned image of a handwritten signature did not satisfy existing signature requirements and offered no proof of a person’s identity. Identification might conceivably be attached to an “advanced electronic signature”, as defined in German law. Generally, however, it was for the legislator and not the courts to establish the conditions for the equivalence between writings and intangible communications transmitted by data transfers.⁶¹ That understanding was eventually reversed in view of the unanimous opinion of the other high federal courts that accepted the delivery of certain procedural pleas by means of electronic communication of a data message accompanied by a scanned image of a signature.⁶²

⁵⁷ The Court of Cassation of France rejected the receivability of a statement of appeal signed electronically, because there were doubts as to the identity of the person who created the signature and the appeal had been signed electronically before entry into force of the law of 13 March 2000, which recognized the legal effect of electronic signatures (Cour de cassation, Deuxième chambre civile, 30 avril 2003, *Sté Chalets Boisson c/ M. X.*, available at www.juriscom.net/jpt/visu.php?ID=239, accessed on 12 September 2003).

⁵⁸ France, Conseil d’État, 28 décembre 2001, N° 235784, *Élections municipales d’Entre-Deux-Monts*, available at www.rajf.org/article.php?id_article=467, accessed on 12 September 2003.

⁵⁹ For instance, Oberlandesgericht (Court of Appeal) Karlsruhe, Case No. 14 U 202/96, 14 November 1997, *JurPC Internet-Zeitschrift für Rechtsinformatik und Informationsrecht*, JurPC Web-Dok. No. 09/1998, available at www.jurpc.de/rechtspr/19980009.htm, accessed on 12 September 2003.

⁶⁰ Germany, Bundesgerichtshof (Federal Court of Justice), Case No. XI ZR 367/97, 29 September 1998, *JurPC Internet-Zeitschrift für Rechtsinformatik und Informationsrecht*, JurPC Web-Dok. No. 05/1999, available at www.jurpc.de/rechtspr/19990005.htm, accessed on 12 September 2003.

⁶¹ Ibid.

⁶² In a decision on a case referred to it by the Bundesgerichtshof of Germany (Federal Court of Justice) (see note [62]), the Gemeinsamer Senat der obersten Gerichtshöfe des Bundes (Joint Chamber of the Highest Federal Courts of Germany) noted that form requirements in court proceedings were not an end in themselves. Their purpose was to ensure a sufficiently reliable (“hinreichend zuverlässig”) determination of the content of the writing and the identity of the person from whom it emanated. The Joint Chamber noted the evolution in the practical application of form requirements to accommodate earlier technological developments such as telex or facsimile. The Joint Chamber held that accepting the delivery of certain procedural pleas by means of electronic communication of a data message with a scanned image of a

34. It is interesting to note that even courts in some civil law jurisdictions that have adopted legislation favouring the use of PKI-based digital signatures, such as Colombia,⁶³ have taken a similarly liberal approach and confirmed, for example, the admissibility of judicial proceedings conducted entirely by electronic communications. The submissions exchanged during such proceedings were valid, even if they were not signed with a digital signature, since the electronic communications used methods that allowed for the identification of the parties.⁶⁴

35. Case law on electronic signatures is still rare and the small number of court decisions to date does not provide a sufficient basis to draw firm conclusions. Nevertheless, a brief review of existing precedents reveals several trends. It seems that the legislative approach taken to electronic signatures and authentication has influenced the attitude of courts on this issue. Arguably, the legislative focus on electronic “signatures”, without an accompanying general rule on attribution, has led to excessive attention being paid to the identity function of authentication methods. This has, in some countries, engendered a certain degree of mistrust vis-à-vis any authentication methods that do not satisfy the statutory definition of an electronic “signature”. It is therefore doubtful that the same courts that have adopted a liberal approach in the context of judicial or administrative appeals would be equally liberal in respect of signature requirements for the validity of contracts. Indeed, while in a contractual context a party might be faced with the risk of repudiation of the agreement by the other party, in the context of civil proceedings it is typically the party using electronic signatures or records that is interested in confirming its approval of the record and its contents.

3. Efforts to develop electronic equivalents for special forms of signature

(a) Apostilles*

36. It has been stated that the spirit and letter of the Convention Abolishing the Requirement of Legalisation for Foreign Public Documents, done at The Hague on 5 October 1961, did not constitute an obstacle to the usage of modern technology.⁶⁵ The First International Forum on e-Notarization and e-Apostilles endorsed this

signature would be in line with the spirit of existing case law (Gemeinsamer Senat der obersten Gerichtshöfe des Bundes, GmS-OGB 1/98, 5 April 2000, *JurPC Internet-Zeitschrift für Rechtsinformatik und Informationsrecht*, JurPC Web-Dok. No. 160/2000, available at www.jurpc.de/rechtspr/20000160.htm, accessed on 12 September 2003).

⁶³ For example, Colombia, which has adopted the UNCITRAL Model Law on Electronic Commerce, including the general provisions of its article 7, but has established a legal presumption of authenticity only in respect of digital signatures (*Ley de comercio electrónico*, art. 28).

⁶⁴ Colombia, Juzgado Segundo Promiscuo Municipal Rovira Tolima, *Juan Carlos Samper v. Jaime Tapias*, 21 julio 2003, Rad. 73-624-40-89-002-2003-053-00. The Court found that the process undertaken via electronic means was valid notwithstanding that the e-mails were not digitally signed because (a) the sender of the data messages could be fully identified; (b) the sender of the data messages consented to and affirmed the content of the data messages sent; (c) the data messages were safely kept in the Tribunal; and (d) the messages could be reviewed at any time (available at www.camara-e.net/_upload/80403--0-7-diaz082003.pdf, accessed on 2 February 2007).

* This section would be further developed in a final version of the comprehensive reference document.

⁶⁵ Hague Conference on Private International Law, “Conclusions and recommendations adopted by the Special Commission on the practical operation of The Hague Apostille, Evidence and Service Conventions: 28 October to 4 November 2003” (The Hague, 2003).

conclusion and noted that the application and operation of the Convention could be further improved by relying on such technologies.⁶⁶ An interpretation of the Convention in the light of the principle of functional equivalence would permit competent authorities both to keep electronic registries and to issue electronic Apostilles, in order to enhance further international legal assistance and government services.

37. In April 2006, the Hague Conference on Private International Law and the National Notary Association (NNA) of the United States launched the electronic Apostille Pilot Program (e-APP). Under the e-APP, the Hague Conference and the NNA are, together with any interested State, developing, promoting and assisting in the implementation of software models for (a) the issuance and use of electronic apostilles (e-apostilles); and (b) the operation of electronic registers of apostilles (e-registers).⁶⁷

(b) Seals

38. Some jurisdictions have already abolished the requirement for seals on the ground that sealing is no longer relevant in today's context. An attested (i.e. witnessed) signature has been substituted.⁶⁸ Other jurisdictions have legislation that allows secure electronic signatures to satisfy the requirement for sealing. For instance, Ireland has specific provisions for secure electronic signatures, with appropriate certification, to be used in place of a seal, subject to the consent of the person or public body to which the document under seal is required or permitted to be given.⁶⁹ Canada provides that requirements for a person's seal under certain federal laws are satisfied by a secure electronic signature that identifies the secure electronic signature as the person's seal.⁷⁰

39. A number of countries have also launched initiatives that contemplate the use of electronic documents and signatures in land transactions involving deeds. The model used in Victoria, Australia, envisages the use of secure digital signature technology via the Internet with digital cards issued by a certification authority. In the United Kingdom, the model envisages execution of deeds by solicitors on behalf of their clients via an Intranet. In some legislation, the possibility of using "electronic seals" as an alternative to "manual seals" is recognized in legislation,

⁶⁶ Conclusions adopted at the First International Forum on e-Notarization and e-Apostilles, held in Las Vegas, United States, on 30 and 31 May 2005, available at www.hcch.net/upload/concl_forum.pdf, accessed on 7 February 2007.

⁶⁷ The e-APP is designed to use already existing and widely used technology. The suggested technology is based on Portable Document Format (PDF) with embedded Extensible Markup Language (XML). More information may be found at http://hcch.e-vision.nl/index_en.php?act=text.display&tid=37, under "Second International Forum on e-Notarization and e-Apostilles", held in Washington, D.C., from 27 to 29 May 2006.

⁶⁸ For example, United Kingdom, Law of Property (Miscellaneous Provisions) Act 1989, which implemented the Law Reform Commission Report on "Deeds and escrows" (Law Com. No. 143, 1987).

⁶⁹ Ireland, Electronic Commerce Act, section 16. However, where the document to be under seal is required or permitted to be given to a public body or to a person acting on behalf of a public body, the public body that consents to the use of an electronic signature may nevertheless require that it be in accordance with particular information technology and procedural requirements.

⁷⁰ Canada, Personal Information Protection and Electronic Documents Act (2000), part 2, section 39. The federal laws referred to are the Federal Real Property and Federal Immovables Act and the Federal Real Property Regulations.

leaving the technical details of the form of the electronic seal to be separately determined.⁷¹

40. The United States Uniform Real Property Electronic Recording Act⁷² expressly states that a physical or electronic image of a stamp, impression or seal need not accompany an electronic signature. Essentially, it is only the information on the seal, rather than the seal itself, that is required. It also provides that any statute, regulation or standard that requires a personal or corporate stamp, impression or seal is satisfied by an electronic signature. These physical indicia are inapplicable to a fully electronic document. Nevertheless, this act requires that the information that would otherwise be contained in the stamp, impression or seal must be attached to, or logically associated with, the document or signature in an electronic fashion.⁷³ Thus, the notarial stamp or impression that is required under the laws of some states is not required for an electronic notarization under this act. Nor is there a need for a corporate stamp or impression as would otherwise be required under the laws of some states to verify the action of a corporate officer.

(c) Notarization*

41. There are three principal United States statutes dealing with notarization: the Uniform Electronic Transactions Act, the Electronic Signatures in Global and National Commerce Act (E-sign)⁷⁴ and the Uniform Real Property Electronic Recording Act.⁷⁵ In combination, they provide that the legal requirements for a document, or a signature associated with a document to be notarized, acknowledged, verified, witnessed or made under oath will be satisfied if the electronic signature of the person authorized to perform those acts, together with all other information required to be included by other applicable law, is attached to or logically associated with the document or signature.

42. In Austria, the cyberDOC electronic document archive, an independent company jointly established by the Austrian Chamber of Civil Law Notaries and Siemens AG, provides notaries with an electronic archive that includes authentication functions.⁷⁶ Austrian notaries are obliged under the law to record and store all notarial deeds perfected after 1 January 2000 in this archive.

⁷¹ Examples are found in requirements relating to the validation of documents by licensed or registered professionals, for example the Engineering and Geoscientific Professions Act (Manitoba, Canada), which defines an “electronic seal” as the form of identification issued by the association of any member to be used in the electronic validation of documents in computer readable form (see <http://apegm.mb.ca/keydocs/act/index.html>, accessed on 4 April 2007).

⁷² The Uniform Real Property Electronic Recording Act of the United States was prepared by the National Conference of Commissioners on Uniform State Laws and is available at www.law.upenn.edu/bll/ulc/urpera/URPERA_Final_Apr05-1.htm, accessed on 7 February 2007. It has been adopted in Arizona, Delaware, the District of Columbia, Kansas, North Carolina, Texas, Virginia and Wisconsin (see www.nccusl.org/Update/uniformact_factsheets/uniformacts-fs-urpera.asp, accessed on 7 February 2007).

⁷³ That is, criteria similar to those embodied in the Uniform Electronic Transactions Act of the United States.

* This section would be further developed in a final version of the comprehensive reference document.

⁷⁴ Codified as United States Code, title 15, chapter 96, sections 7001-7031.

⁷⁵ See note [74].

⁷⁶ See Österreichische Notariatskammer (Austrian Chamber of Civil Law Notaries), available at www.notar.at/de/portal/einrichtungen/cyberdocgmbhcokg/, accessed on 7 February 2007.

(d) Attestation

43. It has been argued that traditional witnessing processes, such as attestation, are not wholly adaptable to the process of electronically signing documents, since there is no assurance that the image on the screen is in fact the document to which the electronic signature will be affixed. All that the witness and the signatory can see is a representation on the computer screen, capable of being read by a human being, of what is allegedly in the memory. When the witness sees the signatory pressing the keyboard, the witness will not know with certainty what is actually happening. Therefore, it would be possible to ensure that the screen display corresponds to the contents of the computer memory and that the signatory's keystrokes correspond to his or her intentions only if the computer has been evaluated to effect a trusted path by trusted evaluation criteria.⁷⁷

44. However, a secure electronic signature would be able to perform a similar function to the attesting witness by identifying the person purporting to sign the deed. Using a secure electronic signature **without a human witness**, it could be possible to verify the authenticity of the signature, the identity of the person to whom the signature belongs, the integrity of the document and probably even the date and time of signing. In this sense, a secure electronic signature may even be superior to an ordinary handwritten signature. The advantages of having, in addition, an actual witness to attest a secure digital signature would probably be minimal unless the voluntary nature of the signing is in question.⁷⁸

45. Existing legislation has not gone so far as to entirely replace attestation requirements with electronic signatures, but merely allows the witness to use an electronic signature. The Electronic Transactions Act of New Zealand provides that the electronic signature of a witness meets the legal requirement for a signature or seal to be witnessed. The technology to be used in making the electronic signature is not specified, as long as it "adequately identifies the witness and adequately indicates that the signature or seal has been witnessed"; and "is as reliable as is appropriate given the purpose for which, and the circumstances in which, the witness's signature is required."⁷⁹

46. The Personal Information Protection and Electronic Documents Act of Canada provides that requirements in federal law for a signature to be witnessed are satisfied with respect to an electronic document if each signatory and each witness signs the electronic document with their secure electronic signature.⁸⁰ A statement required to be made under certain federal laws declaring or certifying that any information given by a person making the statement is true, accurate or complete may be made in electronic form if the person signs it with that person's secure

⁷⁷ This is referred to as the "What you see is what you sign" (WYSIWYS) problem in literature. See V. Liu and others, "Visually sealed and digitally signed documents", Association of Computing Machinery, *ACM International Conference Proceedings Series*, vol. 56, *Proceedings of the Twenty-seventh Australasian Conference on Computer Science*, vol. 26, (Dunedin, New Zealand, 2004) p. 287 (see also for a discussion of trusted display controllers).

⁷⁸ See discussions in Joint Infocomm Development Authority of Singapore and the Attorney-General's Chambers, *Joint IDA-AGC Review of Electronic Transactions Act Stage II: Exclusions under Section 4 of the ETA*, consultation paper LRRD No. 2/2004 (Singapore, 2004), parts 5 and 8, available at www.agc.gov.sg, under "Publications".

⁷⁹ New Zealand, Electronic Transactions Act (see note [9]), section 23, available at www.legislation.govt.nz/browse_vw.asp?content-set=pal_statutes, accessed on 4 April 2007.

⁸⁰ Canada, Personal Information Protection and Electronic Documents Act (see note [72]), part 2, section 46.

electronic signature.⁸¹ A statement required to be made under oath or solemn affirmation under federal law may be made in electronic form if the person who makes the statement signs it with that person's secure electronic signature, and the person before whom the statement was made, and who is authorized to take statements under oath or solemn affirmation, signs it with that person's secure electronic signature.⁸² An alternative that has been suggested to provide further assurance is for the electronic signature to be executed by or in the presence of a trusted professional such as a lawyer or a notary.⁸³

⁸¹ Ibid., section 45.

⁸² Ibid., section 44.

⁸³ Conveyancers will need to have electronic signatures and authentication from a recognized certification authority. Buyers and sellers might need to empower conveyancers to sign by written authority. See "E-conveyancing: the strategy for the implementation of e-conveyancing in England and Wales" (United Kingdom, Land Registry, 2005), available at www.landregistry.gov.uk/assets/library/documents/e-conveyancing_strategy_v3.0.doc, accessed on 7 April 2007. The project is scheduled to be implemented in tranches from 2006 to 2009.

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Comprehensive reference document on elements required to establish a favourable legal framework for electronic commerce: sample chapter on international use of electronic authentication and signature methods

ADDENDUM

The annex to the present note contains part (part two, chap. I, sects. A and B) of a sample chapter of a comprehensive reference document dealing with legal issues related to the international use of electronic authentication and signature methods.

Annex

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Part Two

Cross-border use of electronic signature and authentication methods

I. Legal recognition of foreign electronic authentication and signature methods

1. Legal and technical incompatibilities are the two principal sources of difficulties in the cross-border use of electronic signature and authentication methods, in particular where they are intended to substitute for a legally valid signature. Technical incompatibilities affect the interoperability of authentication systems. Legal incompatibilities may arise because the laws of different jurisdictions impose different requirements in relation to the use and validity of electronic signature and authentication methods.

A. International impact of domestic laws

2. Where domestic laws allow for electronic equivalents of paper-based authentication methods, the criteria for the validity of such electronic equivalents may be inconsistent. For example, if the law recognizes only digital signatures, other forms of electronic signatures will not be acceptable. Other inconsistencies in the criteria for the recognition of electronic authentication and signature methods may not prevent their cross-border use in principle, but the cost and inconvenience arising from the need to comply with the requirements imposed by various jurisdictions may reduce the speed and efficiency gains expected from the use of electronic communications.

3. The following sections discuss the impact of varying legal approaches to technology on the growth of cross-border recognition. They also summarize the emerging international consensus on the measures that could potentially facilitate the international use of electronic signature and authentication methods.

1. International obstacles created by conflicting domestic approaches

4. Technology-neutral approaches, especially those which incorporate a “reliability test”, tend to resolve legal incompatibilities. International legal instruments adopting this approach include the UNCITRAL Model Law on Electronic Commerce, article 7, paragraph 1 (b),¹ and the United Nations Convention on the Use of Electronic Communications in International Contracts, article 9, paragraph 3.² Under this approach, an electronic signature or authentication method that can both identify the signatory and indicate the signatory’s intention in respect of the information contained in the electronic communication will fulfil signature requirements, provided it meets several criteria. In the light of all the circumstances, including any agreement between the originator and the addressee of the data message, the signature or authentication method must be shown to be as reliable as is appropriate for the purpose for which the data

¹ See note [...] [United Nations publication, Sales No. E.99.V.4].

² See note [...] [General Assembly resolution 60/21, annex].

message is generated or communicated. Alternatively, by itself or in conjunction with other evidence, it must be shown to have fulfilled these purposes.

5. Arguably, the minimalist approach facilitates cross-border use of electronic authentication and signatures, since under this approach any method of electronic signature or authentication may be validly used to sign or authenticate a contract or communication, as long as it meets the above general conditions. The consequence of this approach, however, is that such conditions are typically only confirmed *a posteriori*, and there is no assurance that a court will recognize the use of any particular method.

6. Cross-border use of electronic authentication and signatures becomes a real issue in systems that either mandate or favour a particular technology. The complexity of the problem increases in direct relation to the level of governmental regulation of electronic signatures and authentication and the degree of legal certainty that the law attaches to any specific method or technology. The reasons for this are simple: where the law does not attach any particular legal value or presumption to particular types of electronic signature or authentication, and merely provides for their general equivalence to hand-written signatures or paper-based authentication, the risks of reliance on an electronic signature are the same as the risk of reliance on a hand-written signature under existing law. However, where more legal presumptions are attached by the law to a particular electronic signature (typically those regarded as “secure” or “advanced”), the increased level of risk is shifted from one party to another. One fundamental assumption of technology-specific legislation is that such a general *a priori* shift in legal risks may be justified by the level of reliability offered by a given technology, once certain standards and procedures are complied with. The downside to this approach is that once reliability *a priori* is predicated upon the use (among other conditions) of a particular technology, all other technologies — or even the same technology used under slightly different conditions — become *a priori* unreliable, or at least fall under suspicion *a priori* of unreliability.

7. Conflicting technology-specific national legislation may therefore inhibit rather than promote the use of electronic signatures in international commerce. This could happen in two distinct but closely interrelated ways.

8. First, if electronic signatures and the certification services providers who authenticate them are subject to conflicting legal and technical requirements in different jurisdictions, this may inhibit or prevent electronic signatures from being used in many cross-border transactions, if the electronic signature cannot satisfy the various jurisdictional requirements simultaneously.

9. Second, technology-specific legislation, particularly legislation that favours digital signatures, which is also the case in the two-tiered approach, is likely to give rise to a patchwork of conflicting technical standards and licensing requirements that will make the use of electronic signatures across borders very difficult. A system in which each country prescribes its own standards may also prevent parties from entering into mutual recognition and cross-certification agreements.³ Indeed, a

³ Stewart Baker and Matthew Yeo, in collaboration with the secretariat of the International Telecommunication Union, “Background and issues concerning authentication and the ITU”, briefing paper presented to the Experts Meeting on Electronic Signatures and Certification Authorities: Issues for Telecommunications, Geneva, 9 and 10 December 1999, Document No. 2.

major remaining problem relating, in particular, to digital signatures is that of cross-border recognition. The Working Party on Information Security and Privacy (WPSIP) of the Organization for Economic Cooperation and Development (OECD) (hereinafter OECD WPSIP) has noted that although the approach adopted by most jurisdictions appears to be non-discriminatory, differences in local requirements will continue to engender interoperability problems.⁴ For the purposes of the present study, the following weaknesses noted by OECD WPSIP may be relevant:

(a) **Interoperability.** Challenges and limitations to interoperability were found to be prevalent. At the technical level, although there is an abundance of standards, the lack of “core”, common standards for some technologies was cited as a problem. At the legal/policy level, the difficulty in principals understanding their respective trust framework, including assignment of liability and compensation, were cited as factors that were impeding progress. According to OECD WPSIP, this is an area that “would appear to require closer examination and scrutiny with a view to perhaps developing common tools to assist jurisdictions in achieving the level of interoperability desired for a particular application or system”;

(b) **Recognition of foreign authentication services.** The focus of efforts according to OECD WPSIP has been on establishing domestic services. Thus, mechanisms for recognizing foreign authentication services “are generally not very well developed”. On this basis, OECD WPSIP suggests that this “would appear to be an area where further work would be useful. Given that any work in this area would be highly related to the more general subject of interoperability, the topics could be combined”;

(c) **Acceptance of credentials.**⁵ In some cases, the acceptance of the credentials issued by other entities was cited as a barrier to interoperability. As such, OECD WPSIP suggests that consideration could be given to the possibility of developing a set of best practices or guidelines for issuing credentials for authentication purposes. Work may already be under way in several jurisdictions on this issue that could provide useful input to any initiatives of OECD WPSIP in this regard;

(d) **A range of authentication methods in use.** OECD WPSIP found that in virtually all OECD member States, a range of authentication solutions was in use. The methods range from passwords on the one hand, to tokens, digital signatures and biometrics on the other. Depending on the application, and its requirements, the methods can be used alone, or in combination. While many would view this as positive, the information gathered in the OECD WPSIP survey suggests that the range of possibilities is so great that application providers and users run the risk of

⁴ Organization for Economic Cooperation and Development, Working Party on Information Security and Privacy, *The Use of Authentication across Borders in OECD Countries* (DSTI/ICCP/REG(2005)4/FINAL), www.oecd.org/dataoecd/1/10/35809749.pdf, accessed on 2 February 2007.

⁵ A credential is a token given to prove that an individual or a specific device has gone through an authentication process. Credentials that are bound to the user are essential for identification purposes. Bearer credentials may be sufficient for some forms of authorization. Examples are a valid driving licence, a person’s social security number or other identification number, or smart cards. Centre for Democracy and Technology, “Privacy principles for authentication systems”, <http://tprc.org/papers/2003/183/CDTauthenticationTPRC.pdf>, accessed on 12 April 2007; see also Centre for Democracy and Technology, Authentication Privacy Principles Working Group, “Interim report on privacy principles for authentication systems”, www.cdt.org/privacy/authentication/030513interim.pdf, accessed on 12 April 2007.

being hopelessly confused as to which method is appropriate for their requirements. According to OECD WPSIP, this would suggest that there could be some benefit to introducing a reference tool for assessing the various authentication methods and the degree to which their attributes address requirements identified by application providers or users.

10. Confidence in the use of electronic signature and authentication methods in international transactions might be raised by wide adoption of the United Nations Convention on the Use of Electronic Communications in International Contracts and implementation of its technology-neutral approach to electronic signatures and authentication. However, it is unrealistic to expect that this would entirely obviate the need for a harmonized solution for dealing with incompatible legal and technical standards. Many countries may still prescribe the use of specific authentication methods in certain types of transaction. Also, some countries may feel that more concrete guidance is needed to assess the reliability of signature and authentication methods, in particular foreign ones, and their equivalence to methods used or at least known in the country.

2. Emerging consensus

11. The policy divergence that has occurred internationally is probably the result of a combination of factors, in varying degrees. As has been seen earlier (see paras. [...] above), some countries tend to have more stringent and particularized form requirements with respect to signatures and documents, while others focus on the intent of the signing party and permit a broad range of ways to prove the validity of signatures. These general differences usually find their way into specific legislation dealing with electronic authentication and signature methods (see paras. [...] above). An additional source of inconsistency results from the varying degree of governmental interference with technical aspects of electronic authentication and signature methods. Some countries are inclined to play a direct role in setting standards for new technologies, possibly in the belief that this confers a competitive advantage for local industry.⁶

12. The divergent policies may also reflect different assumptions about how authentication technologies will emerge. One scenario, the so-called “universal authentication paradigm”,⁷ assumes that the principal purpose of authentication technologies will be to verify identities and attributes among persons who have no pre-existing relationship with each other and whose common use of technology is not the subject of contractual agreement. Therefore, the authentication or signature technology should confirm the identity or other attributes of a person to a potentially unlimited number of persons and for a potentially unlimited number of purposes. This model stresses the importance of technical standards and of the operational requirements of certification services providers when trusted third parties are involved. Another scenario, the so-called “bounded authentication paradigm” advocates that the principal use of authentication and signature technologies will be to verify identities and attributes among persons whose common use of the technology takes place under contractual agreements.⁸ Therefore, the authentication technology should confirm the identity or other attributes of the certificate holder only for a set of specifically defined purposes and

⁶ See note [...] [Background and issues concerning authentication and the ITU].

⁷ Ibid.

⁸ Ibid.

within a defined community of potentially relying parties who are subject to common terms and conditions for the use of the technology. Under this model, focus is on the legal recognition of the contractual agreements.

13. Despite these discrepancies, some of which still prevail, the findings of OECD WPISP⁹ suggest that there now appears to be a growing international consensus on the basic principles that should govern electronic commerce and in particular electronic signature. The following findings are particularly interesting for the present study:

(a) **Non-discriminatory approach to “foreign” signatures and services.** The legislative frameworks do not deny legal effectiveness to signatures originating from services based in other countries as long as these signatures have been created under the same conditions as those given legal effect domestically. On this basis, the approach appears to be non-discriminatory, as long as local requirements, or their equivalent, are met. This is consistent with findings in previous surveys on authentication done by OECD WPISP;

(b) **Technology neutrality.** While virtually all respondents indicated that their legislative and regulatory framework for authentication services and e-signatures was technology neutral, the majority indicated that, where e-government applications were involved, or where maximum legal certainty of the electronic signature was required, the use of public key infrastructure (PKI) was specified. On that basis, while legislative frameworks may be technology neutral, policy decisions seem to require the technology to be specified;

(c) **PKI prevalence.** According to OECD WPISP, PKI seems to be the authentication method of choice when strong evidence of identity and high legal certainty of the electronic signature is required. It is used in specific “communities of interest” where all users seem to have a prior business relationship of some form. The use of PKI-enabled smart cards and the integration of digital certificate functions into application software, have made the use of this method less complicated for users. However, it is generally acknowledged that PKI is not required for all applications and that the choice of authentication method should be made on the basis of its suitability for the purposes for which it would be used.

14. Furthermore, OECD WPISP found that regulatory frameworks in all the countries surveyed had some form of legislative or regulatory framework in place to provide for the legal effect of electronic signatures at the domestic level. OECD WPISP found that, while the details of the legislation might differ between jurisdictions, a consistent approach appeared nevertheless to be discernible, in that most domestic laws were based on existing international or transnational frameworks (i.e. the UNCITRAL Model Law on Electronic Signatures and Directive 1999/93/EC of the European Parliament and of the Council on a Community framework for electronic signatures¹⁰).

⁹ See note [...] [*The Use of Authentication across Borders in OECD Countries*].

¹⁰ *Official Journal of the European Communities*, L 13/12, 19 January 2000.

B. Criteria for recognition of foreign electronic authentication and signature methods

15. As noted above, one of the main obstacles to the cross-border use of electronic signatures and authentication has been a lack of interoperability, due to conflicting or divergent standards or their inconsistent implementation. Various forums have been established to promote standards-based, interoperable PKI as a foundation for secure transactions in electronic commerce applications. They include both intergovernmental¹¹ and mixed public sector and private sector organizations¹² at a global¹³ or regional level.

16. Some of this technical work aims at developing technical standards for the provision of the information necessary for meeting certain legal requirements.¹⁴

¹¹ In the Asia-Pacific region, the Asia-Pacific Economic Cooperation (APEC) forum has developed “Guidelines for Schemes to Issue Certificates Capable of Being Used in Cross Jurisdiction eCommerce” (eSecurity Task Group, APEC Telecommunications and Information Working Group, December 2004), www.apectelwg.org/contents/documents/eSTG/PKIGuidelines-Final_2_web.pdf, accessed on 12 April 2007. These Guidelines are intended to assist in developing schemes that are potentially interoperable and in reviewing the interoperability of existing schemes. The Guidelines cover classes or types of certificate used in transnational e-commerce only. The Guidelines are not intended to address other certificates, nor are they intended to limit schemes to only issuing certificates covered by the Guidelines.

¹² Within the European Union, the European Electronic Signature Standardization Initiative (EESSI), was created in 1999 by the Information and Communications Technology (ICT) Standards Board to coordinate the standardization activity in support of the implementation of European Union Directive 1999/93/EC on electronic signatures. The ICT Standards Board itself is an initiative of the European Committee for Standardization (CEN), which was created by national standards organizations and two non-profit organizations: the European Committee for Electrotechnical Standardization (CENELEC) and the European Telecommunications Standards Institute (ETSI). EESSI has developed various standards to promote interoperability, but their implementation has been slow, allegedly because of their complexity (Paolo Balboni, “Liability of certification service providers towards relying parties and the need for a clear system to enhance the level of trust in electronic communication”, *Information and Communications Technology Law*, vol. 13, No. 3, 2004), pp. 211-242, 214.

¹³ For example, the Organization for the Advancement of Structured Information Standards (OASIS) is a not-for-profit, international consortium founded in 1993 to promote the development, convergence and adoption of standards for electronic business. OASIS has established a PKI Technical Committee comprised of PKI users, vendors and experts to address issues related to the deployment of digital certificates technology. The OASIS PKI Technical Committee has developed an action plan that contemplates, inter alia, to develop specific profiles or guidelines that describe how the standards should be used in particular applications so as to achieve PKI interoperability; to create new standards, where needed; and to provide interoperability tests and testing events (OASIS, PKI Technical Committee, “PKI action plan” (February 2004), www.oasis-open.org/committees/pki/pkiactionplan.pdf, accessed on 12 April 2007).

¹⁴ For example, the ETSI has developed a standard (TS 102 231) to implement a non-hierarchical structure that, among other things, can address also cross recognition of PKI domains and, therefore, of certificates’ validity. Basically, ETSI technical standard TS 102 231 specifies a standard for the provision of information on the status of a provider of certification services (called a “trust service provider”). It adopts a form of a signed list, the “Trust Service Status List” as the basis for presentation of this information. The Trust Service Status List specified by ETSI accommodates the requirement of evidence as to whether the provider of a trust service is or was operating under the approval of any recognized scheme at either the time the service was

However, to a large extent, this important work is mainly concerned with technical aspects rather than legal issues and falls outside the scope of this study. The discussion in the following sections is therefore focused on the formal and substantive legal requirements for cross-border recognition of electronic signatures.

1. Place of origin, reciprocity and local validation

17. Place of origin has been a classical factor in affording legal recognition to foreign documents or acts. This is typically done on the basis of reciprocity, so that signatures and certificates of a given country will be given domestic effect to the extent that domestic signatures and certificates are given legal effect in the other country. Another related factor is to subject the domestic effect of the foreign signature and certificate to some form of validation or acknowledgement by a domestic certification services provider, certification authority or regulator. Some of them combine all these factors.¹⁵

18. It is not common for domestic laws expressly to deny legal recognition to foreign signatures or certificates, which may confirm the appearance of their non-discriminatory character. In practice, however, many recognition regimes are likely to have some discriminatory impact, even if unintended. The European Union Directive on electronic signatures, for example, generally bans discrimination of foreign qualified certificates (i.e. PKI-based digital signatures). However, this works mainly in favour of certificates issued by certification services providers established within the territory of the States members of the European Union. A certification services provider established in a non-European-Union country has three options to obtain recognition of its certificate in the European Union: fulfil the requirements of the European Union Directive on electronic signatures and obtain accreditation under a scheme established in a member State; establish a cross certification with a certification services provider established in a European Union member State; or operate under the umbrella of a general recognition at the level of international agreement.¹⁶ The manner in which the European Directive regulates

provided, or the time at which a transaction reliant on that service took place. In order to fulfil that requirement, the Trust Service Status List must contain information from which it can be established whether the certification services provider's service was, at the time of the transaction, known by the scheme operator and if so what was the status of the service (i.e. whether it was approved, suspended, cancelled, or revoked). The Trust Service Status List contemplated by ETSI technical standard TS 102 231 must therefore contain not only the service's current status, but also the history of its status. Therefore, the list becomes a combination of valid services ("white list") and cancelled or revoked services ("black list") (see http://portal.etsi.org/stfs/STF_HomePages/STF290/draft_ts_102231v010201p&RGW.doc, accessed on 4 March 2007).

¹⁵ In Argentina, for instance, foreign certificates and electronic signatures are recognized if there is a reciprocity agreement between Argentina and the country of origin of the foreign certification authority or if there is "acknowledgment by a certification authority licensed in Argentina and authenticated by the enforcement authority" (see *Ley de firma digital* (2001), art. 16).

¹⁶ Indeed, under article 7 of the Directive, European Union member States only must ensure that the certificates issued by a certification services provider in a third country are recognized as legally equivalent to certificates issued by a certification services provider established within the Community if (a) the certification services provider "fulfils the requirements laid down in this Directive and has been accredited under a voluntary accreditation scheme established in a Member State"; or (b) a certification services provider established within the Community that fulfils the requirements laid down in the Directive "guarantees" the certificate; or (c) the

international aspects suggests that ensuring conditions for market access abroad of European Union providers of certification services was one of the objectives pursued by the Directive.¹⁷ By cumulating the requirement of substantive equivalence with European Union standards with the additional requirement of “accreditation under a scheme established in a member State”, the European Union Directive on electronic signatures effectively requires foreign certification services providers to comply both with their original and with the European Union regime, which is a higher standard than is required from certification services providers accredited in a State member of the European Union.¹⁸

19. Article 7 of the European Union Directive on electronic signatures has been implemented with some variations.¹⁹ Ireland and Malta, for instance, recognize foreign digital signatures (qualified certificates, under European Union terminology) as equivalent to domestic signatures, as long as other legal requirements are satisfied. In other cases, recognition is subject to domestic verification (Austria, Luxembourg) or a decision of a domestic authority (Czech Republic, Estonia, Poland). This tendency to insist on some form of domestic verification, which is typically justified by a legitimate concern as to the level of reliability of foreign certificates, leads in practice to a system of discrimination of foreign certificates on the basis of their geographic origin.

2. Substantive equivalence

20. Consistent with a long-standing tradition, UNCITRAL declined to endorse geographic considerations when proposing factors for recognition of foreign certificates and electronic signatures. Indeed, article 12, paragraph 1, of the UNCITRAL Model Law on Electronic Signatures expressly provides that in determining whether, or to what extent, a certificate or an electronic signature is legally effective, “no regard shall be had” either to “the geographic location where the certificate is issued or the electronic signature created or used” or to “the geographic location of the place of business of the issuer or signatory.”

21. Paragraph 1 of article 12 of the UNCITRAL Model Law on Electronic Signatures is intended to reflect the basic principle that the place of origin, in and of itself, should in no way be a factor in determining whether and to what extent foreign certificates or electronic signatures should be recognized as capable of being legally effective. Determination of whether, or the extent to which, a certificate or an electronic signature is capable of being legally effective should depend on its technical reliability, rather than the place where the certificate or the electronic signature was issued. Non-discrimination provisions similar to article 12 of the Model Law on Electronic Signatures can also be found in some domestic regimes,

certificate or the certification services provider “is recognized under a bilateral or multilateral agreement between the Community and third countries or international organisations.”

¹⁷ The concern with securing access by European certification services providers to foreign markets is clear from the formulation of article 7, paragraph 3, of the Directive, which provides that “[w]hensoever the Commission is informed of any difficulties encountered by Community undertakings with respect to market access in third countries, it may, if necessary, submit proposals to the Council for an appropriate mandate for the negotiation of comparable rights for Community undertakings in these third countries.”

¹⁸ Jos Dumortier and others, “The legal and market aspects of electronic signatures”, study for the European Commission Directorate General Information Society, Katholieke Universiteit Leuven, 2003, p. 58.

¹⁹ *Ibid.*, pp. 92-94.

such as the United States Electronic Signatures in Global and National Commerce Act 2000.²⁰ These provisions provide that the place of origin, in and of itself, should not be a factor in determining whether and to what extent foreign certificates or electronic signatures should be recognized as capable of being legally effective in an enacting State. They recognize that the legal effectiveness of a certificate or electronic signature should depend on its technical reliability.²¹

22. Rather than geographic factors, the Model Law establishes a test of substantive equivalence between the reliability levels offered by the certificates and signatures in question. Accordingly, if the foreign certificate offers “a substantially equivalent level of reliability” as a certificate issued in the enacting State, it shall have “the same legal effect”. By the same token, an electronic signature created or used outside the country “shall have the same legal effect” as an electronic signature created or used in the country “if it offers a substantially equivalent level of reliability.” The equivalence between the reliability levels offered by the domestic and foreign certificates and signatures must be determined in accordance with recognized international standards and any other relevant factors, including an agreement between the parties to use certain types of electronic signatures or certificates, unless the agreement would not be valid or effective under applicable law.

23. The Model Law does not require or promote reciprocity arrangements. In fact, the Model Law “contains no specific suggestion” as to “the legal techniques through which advance recognition of the reliability of certificates and signatures complying with the law of a foreign country might be made by an enacting State (e.g. a unilateral declaration or a treaty)”.²² Possible methods to achieve that result that were mentioned during the preparation of the Model Law included, for example, automatic recognition of signatures complying with the laws of another State if the laws of the foreign State required a level of reliability at least equivalent to that required for equivalent domestic signatures. Other legal techniques through which advance recognition of the reliability of foreign certificates and signatures might be made by an enacting State could include unilateral declarations or treaties.²³

²⁰ See note [...] [United States Code, title 15, chapter 96, section 7031 (Principles governing the use of electronic signatures in international transactions)].

²¹ See *UNCITRAL Model Law on Electronic Signatures with Guide to Enactment*, part two, para. 83.

²² *Ibid.*, para. 157.

²³ See the report of the Working Group on Electronic Commerce on the work of its thirty-seventh session (A/CN.9/483), paras. 39 and 42.

A/CN.9/630/Add.4 [Original: English]

Comprehensive reference document on elements required to establish a favourable legal framework for electronic commerce: sample chapter on international use of electronic authentication and signature methods

ADDENDUM

The annex to the present note contains part (part two, chap. II, sects. A and B.1) of a sample chapter of a comprehensive reference document dealing with legal issues related to the international use of electronic authentication and signature methods.

Annex

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Part Two

Cross-border use of electronic signature and authentication methods

[...]

II. Methods and criteria for establishing legal equivalence

1. As indicated above, the survey undertaken by the Working Party on Information Security and Privacy (WPISP) of the Organization for Economic Cooperation and Development (OECD) (hereinafter OECD WPISP) found that most legislative frameworks were at least in principle non-discriminatory towards foreign electronic signatures and authentication, provided local requirements or their equivalent were met, in the sense that they did not deny legal effectiveness to signatures relating to services originating from countries, provided those signatures had been created under the same conditions as those recognized under domestic law.¹ However, OECD WPISP also noted that mechanisms for recognizing foreign authentication services were generally not well developed and identified this as an area where future work might be useful. Given that any work in this area would be closely related to the more general subject of interoperability, OECD WPISP suggested that the topics could be combined. OECD WPISP suggested that a set of best practices or guidelines might be developed.

2. The following sections discuss the legal arrangements and mechanisms for international interoperability and factors that determine the equivalence of liability regimes. They focus primarily on issues arising out of the international use of electronic signature and authentication methods supported by certificates issued by a trusted third-party certification services provider, in particular digital signatures under a public key infrastructure (PKI), since legal difficulties are more likely to arise in connection with the cross-border use of electronic signature and authentication methods that require the involvement of third parties in the signature or authentication process.

A. Types and mechanisms of cross recognition

3. The additional burden placed on foreign certification services providers by domestic technology-driven requirements has the potential to become a barrier to international trade.² For example, laws relating to the means by which national authorities grant recognition to foreign electronic signatures and certificates could discriminate against foreign businesses. So far, every legislature that has considered this issue has included in its laws some requirement relating to the standards adhered to by the foreign certification services provider, so the issue is inextricably related to the broader question of conflicting national standards. At the same time,

¹ See note [...] [*The Use of Authentication across Borders in OECD Countries*].

² See Alliance for Global Business, "A discussion paper on trade-related aspects of electronic commerce in response to the WTO's e-commerce work programme", April 1999, www.biac.org/statements/iccp/AGBtoWTOApril1999.pdf, accessed on 5 February 2007, p. 29.

legislation may also impose other geographic or procedural limitations that prevent cross-border recognition of electronic signatures.

4. In the absence of an international PKI, a number of concerns could arise with respect to the recognition of certificates by certification authorities in foreign countries. The recognition of foreign certificates is often achieved by a method called “cross certification”. In such a case, it is necessary that substantially equivalent certification authorities (or certification authorities willing to assume certain risks with regard to the certificates issued by other certification authorities) recognize the services provided by each other, so their respective users can communicate with each other more efficiently and with greater confidence in the trustworthiness of the certificates being issued. Legal issues may arise with regard to cross certifying or chaining of certificates when there are multiple security policies involved, such as determining whose misconduct caused a loss and upon whose representations the user relied.

1. Cross recognition

5. Cross recognition is an interoperability arrangement in which the relying party in the area of a PKI can use authority information in the area of another PKI to authenticate a subject in the area of the other PKI.³ This is typically the result of a formal licensing or accreditation process in the area of the other PKI, or of a formal audit process performed on the representative certification services provider of the PKI area.⁴ The onus of whether to trust a foreign PKI area lies with the relying party or the owner of the application or service, rather than with a certification services provider that the relying party directly trusts.

6. Cross recognition would typically occur at the PKI level rather than at the level of the individual certification services provider. Thus, where a PKI recognizes another PKI, it automatically recognizes any certification services providers accredited under that PKI scheme. Recognition would be based on assessment of the other PKI’s accreditation process rather than assessing each individual certification services provider accredited by the other PKI. Where PKIs issue multiple classes of certificates, the cross-recognition process involves identifying a class of certificates acceptable for use in both areas and basing the assessment on that class of certificates.

7. Cross recognition entails issues of technical interoperability at the application level only, i.e. the application must be able to process the foreign certificate and access the directory system of the foreign PKI area to validate the status of the foreign certificate. It should be noted that, in practice, certification services providers issue certificates with various levels of reliability, according to the purposes for which the certificates are intended to be used by their customers. Depending on their respective level of reliability, certificates and electronic signatures may produce varying legal effects, both domestically and abroad. For example, in certain countries, even certificates that are sometimes referred to as

³ The concept of cross recognition was developed in 2000 by the then Asia-Pacific Economic Cooperation Telecommunications and Information Working Group, Electronic Authentication Task Group, see APEC publication No. 202-TC-01.2, *Electronic authentication: issues relating to its selection and use* (APEC, 2002), available at www.apec.org/apec/publications/all_publications/telecommunications.html, accessed on 7 February 2007.

⁴ Definition based on the work of the APEC Telecommunications and Information Working Group, Electronic Authentication Task Group.

“low-level” or “low-value” certificates might, under certain circumstances (e.g. where parties have agreed contractually to use such instruments), produce legal effect (see below, paras. [42-50]). Therefore, the equivalence to be established is between functionally comparable certificates.

8. As said above, in cross recognition the decision to trust a foreign certificate lies with the relying party, not with its certification services provider. It does not necessarily involve a contract or agreement between two PKI domains. Detailed mapping of certificate policies⁵ and certificate practice statements⁶ is also unnecessary, as the relying party decides whether to accept the foreign certificate based on whether the certificate has been issued by a trustworthy foreign certification services provider. The certification services provider is regarded as trustworthy if it has been licensed or accredited by a formal licensing or accreditation body, or has been audited by a trusted independent third party. The relying party makes an informed decision unilaterally based on the policies stipulated in the certificate policy or certificate practice statement in the foreign PKI domain.

2. Cross certification between public key infrastructures

9. Cross certification refers to the practice of recognizing another certification services provider’s public key to an agreed level of confidence, normally by virtue of a contract. It essentially results in two PKI domains being merged (in whole or in part) into a larger domain. To the users of one certification services provider, the users of the other certification services provider are simply signatories within the extended PKI.

10. Cross certification involves technical interoperability and the harmonization of certificate policies and certificate practice statements. Policy harmonization, in the form of the harmonization of certificate policies and certificate practice statements, is necessary to ensure that PKI domains are compatible both in terms of their certificate management operations (i.e. certificate issuance, suspension and revocation) and in their adherence to similar operational and security requirements. The amount of liability coverage is also relevant. This step is highly complex, as these documents are typically voluminous and deal with a wide range of issues.

11. Cross certification is most suitable for relatively closed business models, e.g. if both PKI domains share a set of applications and services, such as e-mail or financial applications. Having technically compatible and operable systems, congruent policies and the same legal structures would greatly facilitate cross certification.

12. Unilateral cross certification (whereby one PKI domain trusts another but not vice versa) is uncommon. The trusting PKI domain must ensure unilaterally that its policies are compatible with those of the trusted PKI domain. Its use seems to be limited to applications and services where the trust required for the transaction involved is unilateral, e.g. an application in which the merchant has to prove the identity to the customer before the latter submits confidential information.

⁵ A certificate policy is a named set of rules that indicates the applicability of a certificate to a particular community and/or class of application with common security requirements.

⁶ A certificate practice statement is a statement of the practices that a certification services provider employs in issuing certificates.

B. Equivalence of standards of conduct and liability regimes

13. Whether international use of electronic signature and authentication methods is based on a cross-recognition or cross-certification scheme, a decision to recognize a whole PKI or one or more foreign certification services providers, or to establish equivalent levels between classes of certificates issued under different PKIs, presupposes an assessment of the equivalence between the domestic and the foreign certification practices and certificates.⁷ From a legal point of view, this requires an assessment of the equivalence between three main elements: equivalence in legal value; equivalence in legal duties; and equivalence in liability.

14. Equivalence in legal value means attributing to a foreign certificate and signature the same legal effect of a domestic equivalent. The resulting domestic legal effect will be determined essentially on the basis of the value attributed by the domestic law to electronic signature and authentication methods, which has already been discussed (see above, paras. [...]–[...]). Recognizing the equivalence in legal duties and liability regimes entails a finding that the duties imposed on the parties operating under a PKI regime correspond in substance to those existing under the domestic regime and that their liability for breaches of those duties is substantially the same.

15. Liability in the context of electronic signatures may give rise to different issues depending on the technology and the certification infrastructure used. Complex issues may arise especially in those cases where certification is provided by a dedicated third party, such as a certification services provider. In this case, there will essentially be three parties involved, namely the certification services provider, the signatory and the relying third party. To the extent that their acts or omissions cause harm to any of the others, or contravene their express or implied duties, each could become liable, or may lose the right to assert liability, against another party. Various legislative approaches have been adopted with respect to liability in connection with the use of digital signatures:

(a) **No specific provisions on standards of conduct or liability.** One option may be for the law to remain silent on this point. In the United States of America, the Electronic Signatures in Global and National Commerce Act 2000⁸ does not provide for the liability of any of the parties involved in the certification service. Generally speaking, this approach has been adopted in most other jurisdictions taking a minimalist approach to electronic signatures, such as Australia;⁹

⁷ The United States Federal Public Key Infrastructure Policy Authority, Certificate Policy Working Group, for example, has developed a methodology for providing a judgment as to the equivalence between elements of policy (based on the framework defined in RFC (“Request for Comments”) 2527). This methodology may be used when mapping different PKIs or mapping a PKI against these guidelines (see www.cio.gov/fpkipa, accessed on 20 February 2007).

⁸ See note [...] [United States Code, title 15, chapter 96, section 7031 (Principles governing the use of electronic signatures in international transactions)].

⁹ It was felt, for example, that private law mechanisms admitted by Australian law, such as contractual exclusions, waivers and disclaimers of liability, and the limits posed to their operation by the common law, were better suited for regulating liability than statutory provisions (see Mark Sneddon, Legal liability and e-transactions: a scoping study for the National Electronic Authentication Council (National Office for the Information Economy, Canberra, 2000), <http://unpan1.un.org/intradoc/groups/public/documents/APCITY/UNPAN014676.pdf>, accessed on 7 February 2007, pp. 43–47).

(b) **Standards of conduct and liability rules for certification services providers only.** Another approach is for the law to provide only for the liability of the certification services provider. This is the case under European Union Directive 1999/93/EC on a Community framework for electronic signatures,¹⁰ in which recital 22 states that “Certification-service-providers providing certification-services to the public are subject to national rules regarding liability”, as outlined in article 6 of the Directive. It is worth noting that article 6 applies only to “qualified signatures”, which, for the time being, means PKI-based digital signatures only.¹¹

(c) **Standards of conduct and liability rules for signatory and certification services providers.** In some jurisdictions, the law provides for the liability of the signatory and of the certification services provider, but does not establish a standard of care of the relying party. This is the case in China, under the Electronic Signatures Law of 2005. This is also the case in Singapore, under the Electronic Transactions Act, 1998;

(d) **Standards of conduct and liability rules for all parties.** Finally, the law may provide for standards of conduct and a basis for the liability of all parties involved. This approach is adopted in the UNCITRAL Model Law on Electronic Signatures,¹² which indicates the duties relating to the conduct of the signatory (art. 8), of the certification services provider (art. 9) and of the relying party (art. 11). The Model Law can be said to set out criteria against which to assess the conduct of those parties. However, it leaves to the domestic law to determine the consequences of the inability to fulfil the various duties and the basis for the liability that may affect the various parties involved in the operation of electronic signature systems.

16. Differences in domestic liability regimes may be an obstacle to the cross-border recognition of electronic signatures. There are two main reasons for this. Firstly, certification services providers may be reluctant to recognize foreign certificates or the keys issued by foreign certification services providers whose liability or standards of care may be lower than their own. Secondly, users of electronic signature and authentication methods, too, may fear that lower liability limits or standards of care of a foreign certification services provider may limit the remedies available to them in case, for instance, of forgery or false reliance. For the same reasons, where the use of electronic signature and authentication methods, or the activities of certification services providers, is provided for by legislation, the law typically subjects recognition of foreign certificates or certification services providers to some assessment of substantive equivalence with the reliability offered by domestic certificates and certification services providers. The standards of care and levels of liability to which the various parties are subject constitute the main legal benchmark against which the equivalence is measured. Moreover, the ability of the certification services provider to limit or disclaim its liability will also have an impact on the level of equivalence afforded to its certificates.

¹⁰ See note [...] [*Official Journal of the European Communities*, L 13/12].

¹¹ Legislation adopted in the European Union follows this approach, for instance, the German law on electronic signature (SignaturGesetz – SigG) and the related ordinance (SigV), 2001, the Austrian Federal Electronic Signature Law (SigG) and the United Kingdom of Great Britain and Northern Ireland Electronic Signature Regulation 2002, section 4.

¹² See note [...] [United Nations publication, Sales No. E.02.V.8].

1. Basis for liability in a public key infrastructure framework

17. Allocation of liability under a PKI framework is effected essentially in two ways: by means of contractual provisions, or by the law (precedent, statute or both). The relations between the certification services provider and the signatory are typically of a contractual nature and, therefore, liability will typically be based on a breach of either party's contractual obligations. The relations between the signatory and the third party will depend on the nature of their dealing in any concrete instance. They may or may not be based on contract. Lastly, the relations between the certification services provider and the relying third party would in most cases not be based on contract.¹³ Under most legal systems the basis of liability (whether contract or tort) will have extensive and significant consequences for the liability regime, in particular as regards the following elements: (a) the degree of fault that is required to engage a party's liability (in other words, what is the "standard of care" owed by one party to the other); (b) the parties that may claim damages and the extent of damages recoverable by them; and (c) whether and to what extent a party at fault is able to limit or disclaim its liability.

18. It flows from the above not only that the standards of liability will vary from one country to the other, but also that within one country they will vary depending on the nature of the relationship between the party held liable and the injured party. Furthermore, various legal rules and theories may have an impact on one or the other aspect of liability under both a contractual or a common law or statutory liability regime, which sometimes lessens the differences between the two regimes. The present study cannot attempt to offer a complete detailed analysis of these general questions. It will instead focus on questions specifically raised in a PKI context and briefly discuss how domestic laws have approached them.

(a) Standard of care

19. Although different legal systems use different ranking systems and theories, for the purposes of this study it is assumed that the liability of the parties involved in a PKI framework would essentially be based on three possible standards: ordinary negligence or fault; presumed negligence (or fault with reversed burden of proof); and strict liability.¹⁴

(i) Ordinary negligence

20. Under this general standard, a person is legally required to compensate other people for the negative consequences of his or her actions, provided that the relationship to that other person is one that gives rise at law to a duty of care. Furthermore, the standard of care generally required is that of "reasonable care," which may be defined simply as the degree of care that a person of ordinary prudence, knowledge and foresight would exercise in the same or similar

¹³ Steffen Hindelang, in "No remedy for disappointed trust: the liability regime for certification authorities towards third parties outwith the EC Directive in England and Germany compared", *Journal of Information, Law and Technology*, 2002, Issue No. 1, (www2.warwick.ac.uk/fac/soc/law/elj/jilt/2002_1/hindelang, accessed on 6 February 2007), at 4.1.1, discussed in detail the possibility of creating a contractual relationship between the certification services provider and the third party under English law, coming to a negative conclusion. However, there are jurisdictions where a contractual relation might arise.

¹⁴ For the discussion of the liability system in this context, see Balboni, "Liability of certification service providers ..." (see note [...]), pp. 232 ff.

circumstances. In common law jurisdictions, this is often referred to as the “reasonable person” standard, whereas in several civil law jurisdictions this is often referred to as the “good family father” (*bonus pater familias*) standard. Viewed specifically from a business perspective, reasonable care refers to the degree of care that an ordinarily prudent and competent person engaged in the same line of business or endeavour would exercise under similar circumstances. Where liability is generally based on ordinary negligence, it is incumbent upon the injured party to demonstrate that the damage was caused by the other party’s faulty breach of its obligations.

21. Reasonable care (or ordinary negligence) is the general standard of care contemplated in the UNCITRAL Model Law on Electronic Signatures. This standard of care applies to certification services providers in respect of issuance and revocation of certificates and disclosure of information.¹⁵ A number of factors may be used in assessing compliance by the certification services provider with its general standard of care.¹⁶ The same standard also applies to signatories in respect of preventing unauthorized use and safekeeping signature creation devices.¹⁷ The Model Law extends the same general standard of reasonable care to the relying party, which is expected to take reasonable steps to verify both the reliability of an electronic signature and the validity, suspension or revocation of the certificate and to observe any limitation with respect to the certificate.¹⁸

¹⁵ See note [...] [United Nations publication, Sales No. E.02.V.8]. Article 9, paragraph 1, of the Model Law states: “Where a certification service provider provides services to support an electronic signature that may be used for legal effect as a signature, that certification service provider shall”: (...) “(b) Exercise reasonable care to ensure the accuracy and completeness of all material representations made by it that are relevant to the certificate throughout its life cycle or that are included in the certificate; (c) Provide reasonably accessible means that enable a relying party to ascertain from the certificate:” (...); “(d) Provide reasonably accessible means that enable a relying party to ascertain, where relevant, from the certificate or otherwise: (...)”.

¹⁶ See note [...] [*Model Law on Electronic Signatures with Guide to Enactment 2001*]. Paragraph 146 of the Guide to Enactment states “In assessing the liability of the certification service provider, the following factors should be taken into account, inter alia: (a) The cost of obtaining the certificate; (b) The nature of the information being certified; (c) The existence and extent of any limitation on the purpose for which the certificate may be used; (d) The existence of any statement limiting the scope or extent of the liability of the certification service provider; and (e) Any contributory conduct by the relying party. In the preparation of the Model Law, it was generally agreed that, in determining the recoverable loss in the enacting State, weight should be given to the rules governing limitation of liability in the State where the certification service provider was established or in any other State whose law would be applicable under the relevant conflict-of-laws rule.”

¹⁷ See note [...] [United Nations publication, Sales No. E.02.V.8]. Article 8 of the Model Law states: “Where signature creation data can be used to create a signature that has legal effect, each signatory shall: (a) Exercise reasonable care to avoid unauthorized use of its signature creation data; and (b) Without undue delay, utilize means made available by the certification service provider (...), or otherwise use reasonable efforts, to notify any person that may reasonably be expected by the signatory to rely on or to provide services in support of the electronic signature if: (i) The signatory knows that the signature creation data have been compromised; or (ii) The circumstances known to the signatory give rise to a substantial risk that the signature creation data may have been compromised”. Further, the signatory must “exercise reasonable care to ensure the accuracy and completeness of all material representations made by the signatory that are relevant to the certificate throughout its life cycle or that are to be included in the certificate”.

¹⁸ UNCITRAL Model Law on Electronic Signatures (see note [...]), article 11, subparagraphs (a), (b)(i) and (b)(ii).

22. A few countries, typically enacting States of the UNCITRAL Model Law on Electronic Commerce,¹⁹ have adopted the general standard of “reasonable care” for the conduct of the certification services provider.²⁰ In some countries, it appears that a certification services provider will “most likely be held to a general standard of reasonable care”, although the fact that certification services providers, by their nature, will be parties with specialized skills in whom laypersons place trust beyond that extended to normal marketplace participants “may eventually give rise to professional status, or otherwise subject them to a higher duty of care to do what is reasonable given their specialized skills.”²¹ Indeed, as discussed below (see para. 29) this seems to be the situation in most countries.

23. As regards the signatory, some jurisdictions that have adopted the UNCITRAL Model Law on Electronic Signatures provide for a general standard of “reasonable care”.²² In various countries the law includes a more or less extensive list of positive obligations without describing the standard of care or indicating the consequences of failure to comply with those obligations.²³ In some countries, however, the law expressly complements the list of obligations with a general declaration of liability of the signatory for his or her breach,²⁴ which in one case is even of a criminal nature.²⁵ Arguably, there may not be a single standard of care, but a staggered system, with a general standard of reasonable care as a default rule for the signatory’s obligations, which is however raised to a warranty standard in respect of some specific obligations, typically those that relate to accuracy and truthfulness of representations made.²⁶

¹⁹ See note [...] [United Nations publication, Sales No. E.99.V.4].

²⁰ For example, the Cayman Islands, Electronic Transactions Law, 2000, section 28; and Thailand, Electronic Transactions Act (2001), section 28.

²¹ “Certification authority: liability issues”, prepared for the American Bankers Association by Thomas J. Smedinghoff, February 1998 (www.bakernet.com/ecommerce/CA-Liability-Analysis.doc), accessed on 5 February 2007, section 1.1.

²² For example, Thailand, Electronic Transactions Act (2001), section 27.

²³ For example, Argentina, *Ley de firma digital (2001)*, article 25; Cayman Islands, Electronic Transactions Law, 2000, section 31; Chile, *Ley sobre documentos electrónicos, firma electrónica y servicios de certificación de dicha firma (2002)*, article 24; Ecuador, *Ley de comercio electrónico, firmas electrónicas y mensajes de datos*, article 17; India, Information Technology Act, 2000, sections 40-42; Mauritius, Electronic Transactions Act 2000, articles 33-36; Peru, *Ley de firmas y certificados digitales*, article 17; Turkey, Ordinance on the Procedures and Principles Pertaining to the Implementation of Electronic Signature Law (2005), article 15; Tunisia, *Loi relative aux échanges et au commerce électroniques*, article 21; and Venezuela (Bolivarian Republic of), *Ley sobre mensajes de datos y firmas electrónicas*, article 19.

²⁴ China, Electronic Signatures Law, promulgated 2004, article 27; Colombia, *Ley 527 sobre comercio electrónico*, article 40; Mexico, *Código de Comercio: Decreto sobre firma electrónica (2003)*, article 99; Dominican Republic, *Ley sobre comercio electrónico, documentos y firmas digitales (2002)*, articles 53 and 55; Panama, *Ley de firma digital (2001)*, articles 37 and 39; Russian Federation, Federal Law on Electronic Digital Signature (2002), clause 12; Venezuela (Bolivarian Republic of), *Ley sobre mensajes de datos y firmas electrónicas*, article 19; and Viet Nam, Law on Electronic Transactions, article 25.

²⁵ Pakistan, Electronic Transactions Ordinance, 2002, section 34.

²⁶ For example, Singapore, Electronic Transactions Act (chapter 88). Section 37, paragraph 2, of the Act provides that by accepting a certificate the signatory “certifies to all who reasonably rely on the information contained in the certificate that (a) the subscriber rightfully holds the private key corresponding to the public key listed in the certificate; (b) all representations made by the subscriber to the certification authority and material to the information listed in the certificate are true; and (c) all information in the certificate that is within the knowledge of the

24. The situation of the relying party is a peculiar one, because it is unlikely that either the signatory or the certification services provider could be damaged by an act or omission of the relying party. In most circumstances, if the relying party fails to exercise the requisite degree of care, he or she would bear the consequences of his or her actions, but would not incur any liability towards the certification services provider. It is not surprising, therefore, that, when addressing the role of relying parties, domestic laws on electronic signatures seldom provide more than a general list of basic duties of the relying party. This is generally the case in jurisdictions that have adopted the UNCITRAL Model law on Electronic Signatures, which recommends a standard of “reasonable care” in relation to the conduct of the relying party.²⁷ In some cases, however, this requirement is not expressly stated.²⁸ It should be noted that the express or implied duties of the relying party are not irrelevant for the certification services provider. Indeed, a breach by the relying party of its duty of care may provide the certification services provider with a defence against liability claims by a relying party, for example, when the certification services provider can show that the damage sustained by the relying party could have been avoided or mitigated had the relying party taken reasonable measures to ascertain the validity of the certificate or the purposes for which it could be used.

(ii) *Presumed negligence*

25. The second possibility is a fault-based system with a reversed burden of proof. Under this system, a party’s fault is presumed whenever damage has resulted from an act attributable to it. The rationale for such a system is generally the assumption that, under certain circumstances, damage could in the normal course of events only have occurred because a party failed to comply with its obligations or abide by a standard of conduct expected from it.

26. In civil law, presumed fault may occur in connection with liability for breach of contract,²⁹ and also for various instances of tort liability. Examples include

subscriber is true.” Section 39, paragraph 1, in turn only contemplates “a duty to exercise reasonable care to retain control of the private key corresponding to the public key listed in such certificate and prevent its disclosure to a person not authorized to create the subscriber’s digital signature.” This seems also to be the case in the Bolivarian Republic of Venezuela, where article 19 of the *Ley sobre mensajes de datos y firmas electrónicas*, expressly qualifies the obligation to avoid unauthorized use of the signature creation device as one of “due diligence” (“actuar con diligencia”), whereas other obligations are expressed in categorical terms.

²⁷ Cayman Islands, Electronic Transactions Law, 2000, section 21; Mexico, *Código de Comercio: Decreto sobre firma electrónica* (2003), article 107; and Thailand, Electronic Transactions Act (2001), section 30.

²⁸ Turkey, Ordinance on the Procedures and Principles Pertaining to the Implementation of Electronic Signature Law (2005), article 16; and Viet Nam, Law on Electronic Transactions, article 26.

²⁹ Section 280, paragraph 1, of the Civil Code of Germany, for instance, declares the debtor liable for damage arising out of the breach of a contractual obligation unless the debtor is not responsible for the breach (“*Verletzt der Schuldner eine Pflicht aus dem Schuldverhältnis, so kann der Gläubiger Ersatz des hierdurch entstehenden Schadens verlangen. Dies gilt nicht, wenn der Schuldner die Pflichtverletzung nicht zu vertreten hat*”). Article 97, paragraph 1, of the Code of Obligations of Switzerland states this principle in even clearer terms: if the creditor does not obtain performance, the debtor is liable to compensate the resulting damage unless it can prove that the failure to perform was not attributable to its own fault (“*Lorsque le créancier ne peut obtenir l’exécution de l’obligation ou ne peut l’obtenir qu’imparfaitement, le débiteur est tenu de réparer le dommage en résultant, à moins qu’il ne prouve qu’aucune faute ne lui est imputable*”). A similar rule is contained in article 1218 of the Civil Code of Italy. Under French

vicarious liability for the acts of employees, agents, infants or animals, liability arising in the course of some commercial or industrial activity (environmental damage, damage to adjacent property, transportation accidents). The theories justifying the reversal of the burden of proof and the particular instances in which it is admitted vary from country to country.

27. In practice, such a system leads to a result similar to the enhanced standard of care that is expected from professionals under common law. Professionals must have a minimum amount of special knowledge and skills necessary to act as a member of the profession and have a duty to act as a reasonable member of the profession would in a given circumstance.³⁰ This does not necessarily mean that the burden of proof is reversed, but the higher standard of care expected from the professional means in practice that professionals are deemed to be capable of avoiding doing harm to persons that hire their services or whose welfare is otherwise entrusted to them if they act according to those standards. Under certain circumstances, however, the so-called *res ipsa loquitur* doctrine allows courts to presume, absent proof to the contrary, that the occurrence of damage in the “ordinary course of things” is only possible due to a person’s failure to exercise reasonable care.³¹

28. If this rule is applied to the activities of certification services providers, it would mean that whenever a relying party or a signatory sustains a damage as a result of using an electronic signature or certificate, and that damage can be attributed to a failure by the certification services provider to act in accordance with its contractual or statutory obligations, the certification services provider is presumed to have been negligent.

29. Presumed negligence seems to be the prevailing standard used under domestic laws. Under the European Union Directive on electronic signatures, for example, the certification services provider is liable for damages towards any entity that reasonably relies on the qualified certificate unless the certification services provider proves that it has not acted negligently.³² In other words, the certification services provider liability is based on negligence with a reversal of the burden of

law, negligence is always presumed if the contract involved a promise of a certain result (*obligation de résultat*), but negligence must be established where the object of the contract was to offer a standard of performance (*obligation de moyen*), rather than a specific result (see Gérard Légier, “Responsabilité contractuelle”, *Répertoire de droit civil Dalloz*, August 1989, No. 58-68).

³⁰ W. Page Keeton and others, *Prosser and Keeton on the Law of Torts*, 5th ed., (Saint Paul, Minnesota, West Publishing Co., 1984), section 32 at p. 187.

³¹ “There must be reasonable evidence of negligence. But where the thing is shown to be under the management of the defendant or his servants, and the accident is such, as in the ordinary course of things, that it does not happen if those who have the management use proper care, it affords reasonable evidence, in the absence of explanation by the defendants, that the accident arose from want of care.” (C. J. Erle in *Scott v. The London and St. Katherine’s Docks Co.*, Ex. Ch., 3 H & C 596, 601, 159 Eng. Rep. 665, 667 (1865)).

³² See note [...] [*Official Journal of the European Communities*, L 13/12]. Article 6 of the Directive provides a minimum standard of liability. It would be possible for enacting States to strengthen the liability of the certification services provider, for instance by introducing a strict liability regime or extending liability also to non-qualified certificates. However, this has not happened so far and is unlikely to happen since it would place the certification services providers of one country in a disadvantaged position with respect to other European Union certification services providers (Balboni “Liability of certification service providers ...” (see note [...]), p. 222).

proof: the certification services provider must prove that its actions were not negligent, since it is in the best position to do so, having the technical skills and access to the relevant information (both of which signatories and relying third parties might not possess).

30. This is also the case under various domestic laws outside the European Union that provide for an extensive list of duties to be observed by certification services providers, which generally subject them to liability for any loss caused by their failure to comply with their statutory obligations.³³ It is not altogether clear whether all of these laws actually reverse the burden of proof, but several do provide quite explicitly for such a reversal, either generally,³⁴ or in relation to specific obligations.³⁵

31. The preference for a system of presumed fault is arguably the result of concerns that liability based on ordinary negligence would be not be fair to the relying party, which may lack the technological knowledge, as well as the access to relevant information, to satisfy the burden of showing the certification services provider's negligence.

(iii) *Strict liability*

32. Strict liability or "objective liability" (*responsabilité objective*) is a rule used in various legal systems to attach liability to a person (typically manufacturers or operators of potentially dangerous or harmful products or equipment) without a finding of fault or breach of a duty of care. The person is held to be liable simply for placing a defective product on the market or for the malfunctioning of a piece of equipment. Since liability is assumed from the mere fact that loss or damage has occurred, the individual legal elements required to establish an action such as negligence, breach of a warranty, or intentional conduct need not be established.

33. Strict liability is an exceptional rule under most legal systems and is ordinarily not presumed, absent clear statutory language. In the context of electronic signature and authentication methods, strict liability might impose an excessive burden on the

³³ Argentina, *Ley de firma digital* (2001), article 38; Chile, *Ley sobre documentos electrónicos, firma electrónica y servicios de certificación de dicha firma* (2002), article 14; Ecuador, *Ley de comercio electrónico, firmas electrónicas y mensajes de datos*, article 31; Panama, *Ley de firma digital* (2001), article 51; and Tunisia, *Loi relative aux échanges et au commerce électroniques*, article 22.

³⁴ China, Electronic Signatures Law, promulgated 2004, article 28: "If an electronic signatory or a person who relies on an electronic signature incurs a loss as a result of relying on the electronic signature certification service provided by an electronic certification service provider while engaging in civil activities, and if the electronic certification service provider fails to provide evidence that the provider was not at fault, then the electronic certification service provider shall bear liability for damages"; see also Turkey, Electronic Signature Law 2004, article 13: "Electronic Certificate Service Providers shall be liable for compensation for damages suffered by third parties as a result of infringing the provisions of this Law or the ordinances published in accordance with this Law. Liability of compensation shall not occur if the Electronic Certificate Service Provider proves the absence of negligence".

³⁵ Barbados, chapter 308B, Electronic Transactions Act (1998), section 20: "An authorized certification service provider is not liable for errors in the information in an accredited certificate where (a) the information was provided by or on behalf of the person identified in the accredited certificate; and (b) the certification service provider can demonstrate that he has taken all reasonably practical measures to verify that information."; see also Bermuda, Electronic Transactions Act, 1999, section 23, paragraph 2 (b).

certification services provider, which, in turn, might hinder the commercial viability of the industry at an early stage of its development. At present, no country appears to impose strict liability on either the certification services provider or any other parties involved in the electronic signature process. It is true that in countries that provide for a catalogue of positive obligations for certification services providers, the standard of care for certification services providers is typically very high, approaching in some cases a strict liability regime, but the certification services provider can still be released from liability if it can show that it acted with the required diligence.³⁶

(b) Parties entitled to claim damages and extent of damages recoverable

34. One important issue in determining the extent of liability of certification services providers and signatories concerns the group of persons that might be entitled to claim compensation for damage caused by a breach by either party of their contractual or statutory obligations. Another related matter is the extent of the obligation to compensate and the types of damage that should be recompensed.

35. Contractual liability generally follows upon the breach of a contractual obligation. In a PKI context, a contract would usually exist between the signatory and the certification services provider. The consequences of breaches by one of its contractual obligations to another are determined by the words of the contract, as governed by applicable laws of contract. For electronic signatures and certificates, liability outside a clearly defined contractual relationship would typically arise in situations where a person has sustained damage in reasonable reliance on information provided either by the certification services provider or the signatory, which has turned out to be false or inaccurate. Normally, the relying third party does not enter into a contract with the certification services provider and probably does not interact with the certification services provider at all, except for relying on the certification. This may give rise to difficult questions not entirely answered in some jurisdictions.

36. Under most civil law systems, it could be assumed that a certification services provider would be liable for loss sustained by the relying party as a result of reliance on inaccurate or false information even without specific provisions to that effect in specific legislation dealing with electronic signatures. In several jurisdictions, this liability may follow from the general tort liability provision that has been introduced into most civil law codifications,³⁷ with few exceptions.³⁸ In some jurisdictions, an analogy could be drawn between the activities of a certification services provider and notaries public, who are generally held liable for damage caused by negligence in the performance of their duties.

³⁶ For example, Chile, Ecuador and Panama.

³⁷ Article 1382 of the Civil Code of France provides that “whatever” human act that causes damage to someone else obliges the one by whose fault it occurred, to compensate it. This general liability rule has inspired similar provisions in various other countries, such as article 2043 of the Civil Code of Italy and article 483 of the Civil Code of Portugal.

³⁸ The Civil Code of Germany contains three general provisions (sections 823 I, 823 II and 826) and a few specific rules dealing with a number of rather narrowly defined tortious situations. The main provision is section 823 I, which differs from the French Code to the extent that it expressly refers to injury to someone else’s “life, body, health, freedom, property or another right”.

37. In common law jurisdictions, however, the situation may not be so clear. Where a tort is committed in the performance of acts governed by a contract, common law jurisdictions have traditionally required some privity of contract between the tortfeasor and the injured party. Since the relying third party does not enter into a contract with the certification services provider and probably does not interact with the certification services provider at all, except for relying on the false certification, it may be difficult in some common law jurisdictions (absent an explicit statutory provision) for the relying party to establish a cause of action against the certification services provider.³⁹ If there is no privity of contract, a cause of action at tort under the common law would require a showing of a breach of a duty of care owed by the tortfeasor to the injured party. Whether or not for the certification services provider such a duty exists in respect of all possible relying parties is not entirely clear. Generally, the common law is reluctant to subject a person to “liability in an indeterminate amount, for an indeterminate time, to an indeterminate class”⁴⁰ for negligent misrepresentation unless the negligent words “are uttered directly, with knowledge or notice that they will be acted on, to one to whom the speaker is bound by some relation of duty, arising out of public calling, contract or otherwise, to act with care if he acts at all”.⁴¹

38. In this case, the issue at stake is to determine what is the spectrum of persons to whom a certification services provider (or the signatory for that matter) would owe a duty of care. There are basically three standards that may be used to define the spectrum of persons who in such a situation may validly assert claims against the certification services provider:⁴²

(a) **Foreseeability standard.** This is the broadest standard of liability. Under this standard, the signatory or the certification services provider will be liable to any person for whom reliance on the false representations was reasonably foreseeable;

(b) **Standard based on intent and knowledge.** This is a narrower standard that limits liability to loss suffered by a member of the group of the persons for whose benefit and guidance one intends to supply information or knows that the recipient intends to supply it;

(c) **Privity standard.** This is the most limited standard, creating a duty owed solely to the client, or one with whom the information provider had specific contact.

39. The UNCITRAL Model Law on Electronic Signatures does not attempt to circumscribe the universe of persons who may fall under the category of “relying parties”, which could include “any person having or not a contractual relationship

³⁹ For instance, for English common law, an author concludes that “In the absence of legislation, [the certification services provider]’s liability to [the third party] is far from certain, yet [the third party] foreseeably suffers loss as a result of her negligence. Moreover, it is difficult to see how [the third party] can protect itself. If there is no liability, there is at least an arguable lacuna, and negligence on the part of the [certification services provider], in particular, creates a clear lacuna. The common law might fill lacunae, but the process is uncertain and unreliable” (Paul Todd, *E-Commerce Law* (Abingdon, Oxon, Cavendish Publishing Limited, 2005, pp. 149-150). Similar conclusions were reached for Australian law, see Sneddon, *Legal liability and e-transactions* ... (see note [11]), p. 15.

⁴⁰ Words by Judge Cardozo in *Ultramares Corporation v. George A. Touche et al*, Court of Appeals of New York, 6 January 1931, 174 N.E. 441, p. 445.

⁴¹ *Ibid.*, p. 447.

⁴² Smedinghoff, “Certification authority: liability issues” (see note [23]), section 4.3.1.

with the signatory or the certification services provider.”⁴³ Similarly, under the European Union Directive on electronic signatures, the certification services provider is liable for damages towards “any entity or legal or natural person who reasonably relies” on the qualified certificate. The European Union Directive is clearly built around a PKI scheme, since it applies only in cases of digital signatures (qualified certificates). The notion of entity is usually interpreted as referring to third relying parties, and the Directive has been implemented by all but two States in that sense.⁴⁴

40. Like the UNCITRAL Model Law on Electronic Signatures, the European Union Directive on electronic signatures does not narrow down the categories of persons that may qualify as relying parties. It has therefore been suggested that, even under common law, “in the provision of certification services it is self-evident that a certification service provider owes a duty of care towards anyone who may rely upon their certificate in deciding to accept a particular electronic signature in a particular transaction, since the very purpose for which the certificate was issued is to encourage such reliance.”⁴⁵

41. Another point of interest concerns the nature of loss recoverable from a signatory or certification services provider. For instance, in some common law jurisdictions, claims for purely economic losses for product defects are not recoverable in tort. However, cases of intentional fraud, or in some jurisdictions even negligent misrepresentation, are regarded as exceptions to the economic loss rule.⁴⁶ It is interesting to note, in that connection, that the United Kingdom Electronic Signatures Regulations 2002 did not reproduce the provisions on liability of the European Union Directive on electronic signatures. Therefore, standard rules on liability apply, which, in this case, relate to the test of the proximity of the damage.⁴⁷ The amount of damages recoverable is typically left for general contract or tort law. Some laws expressly require certification services providers to purchase liability insurance or otherwise make public to all potential signatories, among other information, the financial guaranties for its possible liability.⁴⁸

(c) Ability to contractually limit or disclaim liability

42. Certification services providers are expected to seek routinely as much as possible to limit their contractual and tort liability towards the signatory and relying parties. As far as the signatory is concerned, limitation clauses will typically be contained in elements of the contract documentation, such as certification practice statements. Such statements may impose a cap to the liability per incident, per series of incidents, per period of time and exclude certain classes of damages. Another technique would be the inclusion in certificates of the maximum amount of the

⁴³ *UNCITRAL Model Law on Electronic Commerce with Guide to Enactment* (see note [...]), para. 150.

⁴⁴ The exceptions being Denmark and Hungary (Balboni, “Liability of certification service providers ...” (see note [...]), p. 220.

⁴⁵ Lorna Brazell, *Electronic Signatures: Law and Regulation* (London, Sweet and Maxwell, 2004), p. 187.

⁴⁶ Smedinghoff, “Certification authority: liability issues” (see note [23]), section 4.5.

⁴⁷ Dumortier and others, “The legal and market aspects of electronic signatures” (see note [...]), p. 215.

⁴⁸ Turkey, *Electronic Signature Law*, 2004, article 13; and Argentina, *Ley de firma digital* (2001), article 21 (a)(1); see also Mexico, *Código de Comercio: Decreto sobre firma electrónica* (2003), article 104 (III).

value of the transaction for which the certificate may be used, or restrict the use of the certificate to certain purposes only.⁴⁹

43. While most legal systems generally recognize the right of contract parties to limit or exclude liability through contractual provisions, this right is usually subject to various limitations and conditions. In most civil law jurisdictions, for instance, a total exclusion of liability for a person's own fault is not admissible⁵⁰ or is subject to clear limitations.⁵¹ Moreover, if the terms of the contract are not freely negotiated, but rather are imposed or pre-established by one of the parties ("adhesion contracts"), some types of limitation clauses may be found to be "abusive" and therefore invalid.

44. In common law jurisdictions a similar result may flow from various theories. In the United States, for instance, courts generally will not enforce contract provisions found to be "unconscionable". Although this concept usually depends on a determination of the particular circumstances of the case, it generally refers to contract terms "which no man in his senses, not under delusion would make, on the one hand, and which no fair and honest man would accept on the other"⁵² and that are characterized by "an absence of meaningful choice on the part of one of the parties together with contract terms which are unreasonably favourable to the other party."⁵³ Similarly to the civil law notion of "contract of adhesion", the doctrine has been applied to prevent instances of "commercial sharp practices" by parties with superior bargaining power.⁵⁴ Not every contract term that comes about this way is invalid. However, although courts generally enforce standard form or adhesion contracts where there is no ability to bargain regarding the terms, even in consumer contracts, sometimes a court will decline to enforce a clause in a standard contract if its insertion amounts to unfair surprise.⁵⁵

45. Lastly, in both civil law and common law systems, consumer protection rules may significantly reduce the ability of a certification services provider to limit its liability vis-à-vis the signatory, in circumstances where the limitation of liability

⁴⁹ See Smedinghoff, "Certification authority: liability issues" (see note [23]), section 5.2.5.4; and Hindelang, "No remedy for disappointed trust ..." (see note [15]), section 4.1.1.

⁵⁰ In France, it is in principle possible to exclude liability arising out of a breach of contract. In practice, however, courts tend to invalidate such clauses whenever it is found that the clause would release the party from the consequences of a breach of a "fundamental" contractual obligation (see Légier, "Responsabilité contractuelle" (see note [...]), nos. 262 and 263).

⁵¹ In most civil law countries, the law prohibits the disclaimer of liability arising out of gross negligence or violation of duty imposed by a rule of public policy. Some countries have explicit rules to this effect, such as article 100 II of the Code of Obligations of Switzerland and article 1229 of the Civil Code of Italy. Other countries, such as Portugal, do not have a similar statutory rule, but achieve essentially the same result as Italy (see António Pinto Monteiro, *Cláusulas Limitativas e de Exclusão de Responsabilidade Civil* (Coimbra, Faculdade de Direito de Coimbra, 1985), p. 217).

⁵² *First Financial Ins. Co. v. Purolator Security, Inc.*, 388 N.E.2d 17, 22 (Ill. Ct. App. 1 Dist. 1979), citing *Hume v. U.S.*, 132 U.S. 406, 410 (1975), cited in Smedinghoff, "Certification authority: liability issues" (see note [23]), section 5.2.5.4.

⁵³ *Ibid.*, citing *Williams v. Walker-Thomas Furniture Co.*, 350 F.2d 315, 320 (D.C. 1965), cited in Smedinghoff, "Certification authority: liability issues" (see note [23]), section 5.2.5.4.

⁵⁴ *First Financial Ins. Co. v. Purolator Security, Inc.*, 388 N.E.2d 17, 22 (Ill. Ct. App. 1 Dist. 1979), cited in Smedinghoff, "Certification authority: liability issues" (see note [23]), section 5.2.5.4.

⁵⁵ Raymond T. Nimmer, *Information Law*, section 11.12[4][a], at 11-37, cited in Smedinghoff, "Certification authority: liability issues" (see note [23]), section 5.2.5.4.

would effectively deprive the signatory of a right or remedy recognized by the applicable law.

46. The possibility for the certification services provider to limit its potential liability vis-à-vis the relying party would in most cases be subject to even greater restrictions. Apart from closed business models where a relying party would be required to adhere to contract terms,⁵⁶ quite often the relying party will not be bound by contract to the certification services provider or even the signatory. Thus, to the extent that the relying party might have a claim at tort against the certification services provider or the signatory, those parties might have no means of effectively limiting their liability, since under most legal systems this would require giving the relying party adequate notice of the limitation of liability. Lack of knowledge of the identity of the relying party prior to the occurrence of the damage may prevent the certification services provider (and arguably even more so, the signatory) from putting in place an effective system for limiting its liability. This problem is typical of open systems where strangers interact with no prior contact and leaves the signatory exposed to potentially devastating consequences.⁵⁷ This situation was felt by many, in particular representatives of the certification industry, to be a major impediment to wider use of electronic signature and authentication methods, given the difficulty for certification services providers to assess their exposure to liability.

47. The desire to clarify the law on this aspect has led a number of countries to expressly recognize the right of certification services providers to limit their liability. The European Union Directive on electronic signatures, for example, obliges European Union member States to ensure that a certification services provider may indicate in a qualified certificate “limitations on the use of that certificate” as long the limitations “are recognizable to third parties”.⁵⁸ These limitations may be typically of two categories: there may be limits on the types of transaction for which particular certificates or classes of certificates may be used; there may also be limits on the value of the transactions in connection with which the certificate or class of certificates may be used. Under either hypothesis, the certification services provider is expressly exempted from liability “for damage arising from use of a qualified certificate that exceeds the limitations placed on it.”⁵⁹ Furthermore, the European Union Directive on electronic signatures mandates European Union member States to ensure that a certification services provider “may indicate in the qualified certificate a limit on the value of transactions for which the certificate can be used, provided that the limit is recognizable to third parties.”⁶⁰ In such a case the certification services provider shall not be liable for damage resulting from this maximum limit being exceeded.⁶¹

48. The European Union Directive on electronic signatures does not establish a cap for the liability that the certification services provider may incur. However, the directive does allow a certification services provider to limit the maximum value per transaction for which certificates may be used, exempting the certification services

⁵⁶ Such as envisaged for the E-Authentication Federation administered by the General Services Administration of the United States Government (see E-Authentication Federation, Interim Legal Document Suite, version 4.0.7, available at www.cio.gov/eaauthentication/documents/LegalSuite.pdf, accessed on 8 February 2007).

⁵⁷ Sneddon, “*Legal liability and e-transactions ...*” (see note [11]), p. 18.

⁵⁸ European Union Directive on electronic signatures (see note [...]), article 6, paragraph 2.

⁵⁹ Ibid.

⁶⁰ Ibid., article 6, paragraph 3.

⁶¹ Ibid.

provider from liability exceeding that value cap.⁶² As a matter of business practice, certification services providers also often introduce an overall cap to their liability, on a contractual basis.

49. Several other domestic laws support those contractual practices by recognizing a limit on the liability of the certification services provider towards any potentially affected party. Typically, these laws allow limitations as specified in the certificate of practice statement of the certification services provider, and in some cases expressly exempt the certification services provider from liability where a certificate was used for a purpose different from the one for which it was issued.⁶³ Furthermore, some laws recognize the right of certification services providers to issue certificates of different classes and to establish different recommended levels of reliance,⁶⁴ which typically provide different levels of limitation (and of security) depending on the fee paid. However, some laws expressly prohibit any limitations of liability other than as a result of limitations on the use or value of certificates.⁶⁵

50. Countries that have adopted a minimalist approach have, in turn, regarded legislative intervention as generally undesirable and have preferred to leave the matter for the parties to regulate by contract.⁶⁶

⁶² Dumortier and others, “The legal and market aspects of electronic signatures” (see note [...]), p. 55, and discussion in Hindelang, “No remedy for disappointed trust ...” (see note [15]), section 4.1.1. Balboni, “Liability of certification service providers ...” (see note [...]), p. 230, goes further by stating that “... by article 6 (4), it is only possible to limit the value of the transaction (...), which has nothing to do with a limitation of the potential amount of damage that can arise from that transaction.”

⁶³ Argentina, *Ley de firma digital (2001)*, article 39; Barbados, chapter 308B, Electronic Transactions Act (1998), section 20, paragraphs 3 and 4; Bermuda, Electronic Transactions Act, 1999, section 23, paragraphs 3 and 4; Chile, *Ley sobre documentos electrónicos, firma electrónica y servicios de certificación de dicha firma (2002)*, article 14; and Viet Nam, Law on Electronic Transactions, article 29, paragraphs 7 and 8 (the latter however without express exemption of liability).

⁶⁴ Singapore, Electronic Transactions Act (chapter 88) 1998, sections 44 and 45; and Mauritius, Electronic Transactions Act 2000, articles 38 and 39.

⁶⁵ Turkey, Electronic Signature Law, 2004, article 13.

⁶⁶ See, for Australia, Sneddon, *Legal liability and e-transactions* (see note [11]), pp. 44-47; and for the United States, Smedinghoff, “Certification authority: liability issues” (see note [23]), section 5.2.51.

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**Comprehensive reference document on elements required to establish a
favourable legal framework for electronic commerce: sample chapter on
international use of electronic authentication and signature methods**

ADDENDUM

The annex to the present note contains the final part of a sample chapter (part two, chap. II, sect. B.2) dealing with legal issues related to the international use of electronic authentication and signature methods.

Annex

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Part Two

**Cross-border use of electronic signature and authentication
methods (*continued*)**

[...]

II. Methods and criteria for establishing legal equivalence

B. Equivalence of standards of conduct and liability regimes

2. Particular instances of liability in a public key infrastructure framework

1. The main focus of discussions concerning liability in connection with the use of electronic signature and authentication methods has been the basis and

characteristics of the liability of certification services providers. It is generally accepted that the basic duty of a certification services provider is to utilize trustworthy systems, procedures and human resources and to act in accordance with representations that the certification services provider makes with respect to its policies and practices.¹ In addition, the certification services provider is expected to exercise reasonable care to ensure the accuracy and completeness of all material representations it makes in connection with a certificate. All these activities may expose a certification services provider to a varying degree of liability, depending on the applicable law. The following paragraphs identify the instances that carry a greater risk for a certification services provider of being exposed to liability and summarize the way in which domestic laws deal with such liability.

(a) Failure to issue or delay in issuing a certificate

2. A certification services provider typically issues certificates upon application by candidate signatories. If an application meets the certification services provider's criteria, the certification services provider may issue a certificate. It is conceivable that an applicant might meet the criteria but nevertheless be rejected or delayed, either because the certification services provider simply makes a mistake, or because the certification services provider's application facilities are unavailable by design or accident, or because the certification services provider, for ulterior motives, wishes to delay or deny issuance of a certificate to the applicant. Applicants rejected or delayed under these circumstances may have claims against the certification services provider.²

3. If there is a competitive market for certification services, there might be no real harm to an applicant if a certification services provider were to refuse to issue a certificate, either by accident or on purpose. However, in the absence of meaningful competition, a certification services provider's refusal to issue a certificate or delay in issuing a certificate could cause serious harm where the rejected applicant is unable to engage in a particular business without the certificate. Even if competitive alternatives were available, one could envision transaction-specific losses arising from circumstances where a certificate was requested in connection with a particular transaction and, as a result of delay or denial, the certificate was not available in time for the intended transaction, forcing the applicant to forego the valuable transaction.³

4. This kind of scenario is unlikely to arise in an international context, since most signatories would be more likely to seek the services of certification services providers located in their own countries.

(b) Negligence when issuing a certificate

5. The principal function of a certificate is to bind an identity of the signatory to a public key. Accordingly, the principal task of a certification services provider is to verify, in conformance with its stated practices, that an applicant is the purported signatory and is in control of the private key corresponding to the public key listed in the certificate. Failure to do so may expose the certification services provider to potential liability to the signatory, or to a third party that relies on the certificate.

¹ UNCITRAL Model Law on Electronic Signatures (see note [...]), article 9, subparagraphs 1 (a) and 1 (b).

² Smedinghoff, "Certification authority: liability issues" (see note [...]), section 3.2.1.

³ Ibid.

6. Damage to the signatory might be caused, for example, by the erroneous issuance of a certificate to an impostor using a misappropriated identity. The certification services provider's own employees or contractors might conspire to issue erroneous certificates using the certification services provider's signing key against improper applications by the impostor. Those persons might negligently issue an erroneous certificate, either by failing to perform properly the certification services provider's stated validation procedures in reviewing the impostor's application, or by using the certification services provider's signing key to create a certificate that has not been approved. Lastly, a malefactor might impersonate a signatory using forged, but seemingly authentic, identification documents, and convince the certification services provider, despite careful and non-negligent adherence to its published policies, to issue a certificate to the impostor.⁴

7. Erroneous issuance to an impostor could have very serious consequences. Relying parties who conduct online transactions with the impostor may rely on the incorrect data in the erroneously issued certificate and, as a result of that reliance, ship goods, transfer funds, extend credit, or undertake other transactions with the expectation that they are dealing with the impersonated party. When the fraud is discovered, the relying parties may have suffered substantial loss. In this situation, there are two injured parties: the relying party who was defrauded by the erroneously issued certificate, and the person whose identity was impersonated in the erroneously issued certificate. Both will have claims against the certification services provider. Another scenario might be the negligent issuance of a certificate to a fictitious person, in which case only the relying party would suffer damage.⁵

8. Article 9 of the UNCITRAL Model Law on Electronic Signatures provides, *inter alia*, that a certification services provider shall "exercise reasonable care to ensure the accuracy and completeness of all material representations made by it that are relevant to the certificate throughout its life cycle or that are included in the certificate". This general duty has been literally transposed into the domestic legislation of several countries implementing the Model Law,⁶ although in some countries the standard seems to have been raised from "reasonable care" to a higher warranty standard.⁷

9. The regime established by the European Union Directive on electronic signatures obliges European Union member States, as "a minimum", to ensure that by issuing a certificate as a qualified certificate to the public, or by guaranteeing such a certificate to the public, a certification services provider is liable for damage caused to any entity or legal or natural person who reasonably relies on that certificate: (a) as regards the accuracy at the time of issuance of all information contained in the qualified certificate and as regards the fact that the certificate contains all the details prescribed for a qualified certificate; (b) for assurance that, at the time of the issuance of the certificate, the signatory identified in the qualified

⁴ Ibid.

⁵ Ibid.

⁶ For example, Thailand, Electronic Transactions Act (2001), section 28, paragraph 2; and Cayman Islands (overseas territory of the United Kingdom), Electronic Transactions Law, 2000, section 28 (b).

⁷ For example, China, Electronic Signatures Law, article 22: "Electronic certification service providers **shall ensure** that the contents of electronic signature certificates are complete and accurate during their valid term, and shall ensure that parties relying on electronic signatures can verify or comprehend all of the recorded contents of electronic signature certificates and other relevant matters", emphasis added.

certificate held the signature-creation data corresponding to the signature-verification data given or identified in the certificate; (c) for assurance that the signature-creation data and the signature-verification data can be used in a complementary manner in cases where the certification services provider generates them both; unless the certification services provider proves that he has not acted negligently.⁸

10. Other domestic laws generally coincide in imposing on certification services providers the obligation to verify the accuracy of the information on the basis of which a certificate is issued. In some countries, a certification services provider is generally held liable to any person who reasonably relied on the certificate for the accuracy of all information in the accredited certificate as from the date on which it was issued,⁹ or guarantees its accuracy,¹⁰ although in some of those countries the certification services provider may qualify this warranty by an appropriate statement in the certificate.¹¹ Some laws, however, expressly exempt the certification services provider from liability for inaccurate signatory-provided information, subject to verification according to the certificate practice statement, provided that the certification services provider can prove that it took all reasonable measures to verify the information.¹²

11. In other countries the same result is achieved not by a statutory warranty, but by imposing on certification services providers a general duty to verify the information supplied by the signatory before issuing a certificate,¹³ or to establish systems for verifying such information.¹⁴ In some cases, there is an obligation to revoke a certificate immediately upon finding out that information on which the certificate was issued was inaccurate or false.¹⁵ In a few cases, however, the law is silent about the issuance of certificates, merely requiring the certification services provider to comply with its certification practice statement¹⁶ or to issue the certificate as agreed with the signatory.¹⁷ This does not mean that the law does not contemplate any liability for certification services providers. On the contrary, some laws clearly contemplate certification services provider liability, by requiring the certification services provider to purchase adequate third-party liability insurance

⁸ European Union Directive on electronic signatures (see note [...]), article 6, paragraph 1.

⁹ Barbados, chapter 308B, Electronic Transactions Act (1998), section 20, paragraph 1 (a); Bermuda, Electronic Transactions Act, 1999, section 23; Hong Kong (Special Administrative Region (SAR) of China), Electronic Transactions Ordinance, section 39; India, Information Technology Act, 2000, section 36 (e); Mauritius, Electronic Transactions Act 2000, section 27, paragraph 2 (d); and Singapore, Electronic Transactions Act, sections 29, subsection (2)(a) and (c), and 30, subsection (1).

¹⁰ Tunisia, *Loi relative aux échanges et au commerce électroniques*, article 18; and Viet Nam, Law on Electronic Transactions, article 31 (d).

¹¹ For example, Barbados, Bermuda, Hong Kong SAR, Mauritius and Singapore.

¹² Argentina, *Ley de firma digital (2001)*, article 39 (c).

¹³ Ibid., article 21 (o); Chile, *Ley sobre documentos electrónicos, firma electrónica y servicios de certificación de dicha firma*, article 12 (e); Mexico, *Código de Comercio: Decreto sobre firma electrónica (2003)*, article 104 (I); and Venezuela (Bolivarian Republic of), *Ley sobre mensajes de datos y firmas electrónicas*, article 35.

¹⁴ Ecuador, *Ley de comercio electrónico, firmas electrónicas y mensajes de datos*, article 30 (d).

¹⁵ Argentina, *Ley de firma digital (2001)*, article 19 (e)(2).

¹⁶ Peru, *Decreto reglamentario de la ley de firmas y certificados digitales*, article 29 (a).

¹⁷ Colombia, *Ley 527 sobre comercio electrónico*, article 32 (a); Dominican Republic, *Ley sobre comercio electrónico, documentos y firmas digitales (2002)*, article 40 (a); and Panama, *Ley firma digital (2001)*, article 49, paragraph 7.

covering all contractual and extra-contractual damage caused to signatories and third parties.¹⁸

12. The certification services provider's duty to verify the accuracy of the information that is provided is supplemented by a duty of the signatory to "exercise reasonable care to ensure the accuracy and completeness of all material representations made by the signatory that are relevant to the certificate throughout its life cycle or that are to be included in the certificate."¹⁹ The signatory could therefore be held liable, either to the certification services provider or to the relying party, for providing false or inaccurate information to the certification services provider when applying for a certificate. Sometimes this is formulated as a general duty to provide accurate information to the certification services provider,²⁰ or to exercise reasonable care to ensure the correctness of the information,²¹ sometimes the signatory is expressly declared liable for damages resulting from its failure to comply with this particular requirement.²²

(c) Unauthorized use of signature or compromised certificate practice statement

13. There are two aspects of unauthorized use of signature creation devices and certificates. On the one hand, a signature creation device might not be properly kept or be otherwise compromised, for instance by misappropriation by an agent of the signatory. On the other hand, the actual signing hierarchy of the certification services provider might be compromised, for instance if either the certification services provider's own signing key or the root key are lost, or disclosed to or used by unauthorized persons, or otherwise compromised.

14. The signing hierarchy might be compromised in various ways. The certification services provider or one of its employees or contractors might accidentally destroy or lose control of the key, the data centre that held the private key might be damaged by an accident, or the certification services provider's key might be destroyed intentionally or compromised by someone for unlawful purposes (e.g. a hacker). The consequences of a compromise of the signing hierarchy could be very serious. For instance, if either the private signing key or the root keys were to fall into the hands of a malefactor, that person could generate false certificates and use them to impersonate real or fictitious signatories, to the detriment of relying parties. Furthermore, once the damage was discovered, all certificates issued by the certification services provider would need to be revoked, resulting in a potentially massive claim by the entire signatory community for loss of use.

15. This matter is not dealt with in detail in the UNCITRAL Model law on Electronic Signatures. Arguably, the general obligation of the certification services provider under the Model Law to "use trustworthy systems, procedures and human

¹⁸ Bolivarian Republic of Venezuela, *Ley sobre mensajes de datos y firmas electrónicas*, article 32.

¹⁹ UNCITRAL Model Law on Electronic Signatures (see note [...]), article 8, subparagraph 1 (c).

²⁰ Argentina, *Ley de firma digital (2001)*, article 25; Chile, *Ley sobre documentos electrónicos, firma electrónica y servicios de certificación de dicha firma (2002)*, article 24; and Mexico, *Código de Comercio: Decreto sobre firma electrónica (2003)*, article 99 (III).

²¹ Cayman Islands, *Electronic Transactions Law 2000*, section 31 (c).

²² Colombia, *Ley 527 sobre comercio electrónico*, article 40; Dominican Republic, *Ley sobre comercio electrónico, documentos y firmas digitales (2002)*, article 55; Mexico, *Código de Comercio: Decreto sobre firma electrónica (2003)*, article 99 (III); and Panama, *Ley de firma digital (2001)*, article 39.

resources”²³ could be construed as imposing a duty on a certification services provider to take all necessary measures to prevent its own key (and thereby its entire signing hierarchy) from being compromised. Several domestic laws explicitly provide for such an obligation, often combined with the certification services provider’s obligation to utilize trustworthy systems.²⁴ Sometimes there is a specific duty to take measures to avoid forgery of certificates.²⁵ A certification services provider is under a duty to refrain from creating or accessing the signature creation data of the signatories, and may be liable for acts of its employees that deliberately do so.²⁶ A certification services provider would be placed under a duty to request the revocation of its own certificate, if its signature creation data is compromised.²⁷

16. The signatory is also required to exercise all due care. The UNCITRAL Model Law on Electronic Signatures, for example, requires the signatory to “exercise reasonable care to avoid unauthorized use of its signature creation data”.²⁸ A similar duty exists under most domestic laws, although with some variations. In some cases, the law subjects the signatory to a strict obligation to ensure exclusive control over the signature creation device and prevent its unauthorized use,²⁹ or makes the signatory solely responsible for safekeeping the signature creation device.³⁰ Often, however, this obligation is qualified as a duty to keep adequate control over the signature creation device or to take adequate measures to keep control over it,³¹ to act diligently to avoid unauthorized use,³² or to exercise reasonable care to avoid unauthorized use of its signature device.³³

²³ UNCITRAL Model Law on Electronic Signatures (see note [...]), article 9, subparagraph 1 (f).

²⁴ Argentina, *Ley de firma digital (2001)*, article 21 (c) and (d); Colombia, *Ley 527 sobre comercio electrónico*, article 32 (b); Mauritius, Electronic Transactions Act 2000, article 24; Panama, *Ley de firma digital (2001)*, article 49, paragraph 5; Thailand, Electronic Transactions Act (2001), section 28, paragraph 6; and Tunisia, *Loi relative aux échanges et au commerce électroniques*, article 13.

²⁵ Bolivarian Republic of Venezuela, *Ley sobre mensajes de datos y firmas electrónicas*, article 35.

²⁶ Argentina, *Ley de firma digital (2001)*, article 21 (b).

²⁷ Ibid., article 21 (p).

²⁸ UNCITRAL Model Law on Electronic Signatures (see note [...]), article 8, subparagraph 1 (a).

²⁹ Argentina, *Ley de firma digital (2001)*, article 25 (a); Colombia, *Ley 527 sobre comercio electrónico*, article 39, paragraph 3; Dominican Republic, *Ley sobre comercio electrónico, documentos y firmas digitales (2002)*, article 53 (d); Panama, *Ley de firma digital (2001)*, article 37, paragraph 4; Russian Federation, Federal Law on Electronic Digital Signature (2002), clause 12, paragraph 1; and Turkey, Ordinance on the Procedures and Principles Pertaining to the Implementation of Electronic Signature Law (2005), article 15 (e).

³⁰ Tunisia, *Loi relative aux échanges et au commerce électroniques*, article 21.

³¹ Chile, *Ley sobre documentos electrónicos, firma electrónica y servicios de certificación de dicha firma (2002)*, article 24; and Viet Nam, Law on Electronic Transactions, article 25, paragraph 2 (a).

³² Bolivarian Republic of Venezuela, *Ley sobre mensajes de datos y firmas electrónicas*, article 19.

³³ Cayman Islands, Electronic Transactions Law, 2000, section 39 (a); Ecuador, *Ley de comercio electrónico, firmas electrónicas y mensajes de datos*, article 17 (b); India, Information Technology Act, 2000, section 42, paragraph 1; Mauritius, Electronic Transactions Act 2000, section 35, paragraph 1 (a) and (b); Mexico, *Código de Comercio: Decreto sobre firma electrónica (2003)*, article 99 (II); Singapore, Electronic Transactions Act (chapter 88), section 39; and Thailand, Electronic Transactions Act (2001), section 27, paragraph 1.

(d) Failure to suspend or revoke a certificate

17. The certification services provider could also incur liability for failing to suspend or revoke a compromised certificate. For a digital signature infrastructure to function properly and enjoy trust, it is critical that a mechanism be in place to determine in real time whether a particular certificate is valid, or whether it has been suspended or revoked. Whenever a private key is compromised, for example, revocation of the certificate is the primary mechanism by which a signatory can protect itself from fraudulent transactions initiated by impostors who may have obtained a copy of their private key.

18. As a consequence, the speed with which the certification services provider revokes or suspends a signatory's certificate following a request from the signatory is critical. The lapse of time between a signatory's request to revoke a certificate, the actual revocation and the publication of the notice of revocation, could allow an impostor to enter into fraudulent transactions. Consequently, if the certification services provider unreasonably delays posting a revocation to a certificate revocation list, or fails to do so, both the signatory and the defrauded relying party could suffer significant damages in reliance upon an allegedly valid certificate. Furthermore, as part of their certification services, certification services providers may offer to maintain online depositories and certificate revocation lists that will be accessible by relying parties. Maintaining this database involves two basic risks: that the repository or certificate revocation list might be inaccurate, thereby providing erroneous information upon which the recipient will rely to its detriment; and the risk that the repository or certificate revocation list will be unavailable (e.g. because of system failure), thereby interfering with the ability of signatories and relying parties to complete transactions.

19. As indicated earlier, the UNCITRAL Model Law on Electronic Signatures assumes that the certification services provider may issue various levels of certificates with varying degrees of reliability and security. Accordingly, the Model Law does not require a certification services provider to always make available a revocation system, which may not be commercially reasonable for certain types of low-value certificate. Instead, the Model Law only requires the certification services provider to provide "reasonably accessible means" that enable a relying party to ascertain from the certificate, *inter alia*, "whether means exist for the signatory to give notice" that the signature creation data have been compromised and "whether a timely revocation service is offered".³⁴ Where a timely revocation service is offered, the certification services provider is obliged to ensure its availability.³⁵

20. The regime established by the European Union Directive on electronic signatures obliges European Union member States, as "a minimum", to ensure that a certification services provider who has issued a certificate as a qualified certificate to the public is liable for damage caused to any entity or legal or natural person who reasonably relies on the certificate for failure to register revocation of the certificate, unless the certification services provider proves that it has not acted negligently.³⁶ Some domestic laws oblige the certification services provider to take

³⁴ UNCITRAL Model Law on Electronic Signatures (see note [...]), article 9, subparagraph 1 (d), (v) and (vi).

³⁵ *Ibid.*, article 9, subparagraph 1 (e).

³⁶ European Union Directive on electronic signatures (see note [...]), article 6, paragraph 2; see also paragraph (b) of annex II to the Directive.

measures to prevent certificate forgery³⁷ or to revoke a certificate immediately upon finding out that information on which the certificate was issued was inaccurate or false.³⁸

21. A similar duty may also exist for the signatory and other authorized persons. The UNCITRAL Model Law on Electronic Signatures, for example, requires the signatory “without undue delay”, to “utilize means made available by the certification service provider”, or “otherwise use reasonable efforts, to notify any person that may reasonably be expected by the signatory to rely on or to provide services in support of the electronic signature” if the signatory “knows that the signature creation data have been compromised” or if “circumstances known to the signatory give rise to a substantial risk that the signature creation data may have been compromised”.³⁹

22. Domestic laws often affirm the duty of the signatory to request revocation of the certificate in any circumstance where the secrecy of the signature creation data might have been compromised,⁴⁰ although in some cases the law only obliges the signatory to communicate that fact to the certification services provider.⁴¹ The laws of several countries have adopted the formulation in the UNCITRAL Model Law on Electronic Signatures, which places the signatory under an obligation to further notify any person who may reasonably be expected by the signature device holder to rely on or to provide services in support of the electronic signature.⁴² Although the consequences of breach of this duty may be implied in a number of legal systems, in some countries the law expressly declares the signatory liable for failure to communicate the loss of control over the private key or failure to request the revocation of the certificate.⁴³

³⁷ Panama, *Ley de firma digital (2001)*, article 49, paragraph 6.

³⁸ Argentina, *Ley de firma digital (2001)*, article 19 (e)(2).

³⁹ UNCITRAL Model Law on Electronic Signatures (see note [...]), article 8, subparagraph 1 (b), (i) and (ii).

⁴⁰ Argentina, *Ley de firma digital (2001)*, article 25 (c); Colombia, *Ley 527 sobre comercio electrónico*, article 39, paragraph 4; Dominican Republic, *Ley sobre comercio electrónico, documentos y firmas digitales (2002)*, articles 49 and 53 (e); Ecuador, *Ley de comercio electrónico, firmas electrónicas y mensajes de datos*, article 17 (f); Mauritius, Electronic Transactions Act 2000, article 36; Panama, *Ley de firma digital (2001)*, article 37, paragraph 5; Singapore, Electronic Transactions Act (chapter 88), section 40; and Russian Federation, Federal Law on Electronic Digital Signature (2002), clause 12, paragraph 1.

⁴¹ India, Information Technology Act, 2000, section 42, paragraph 2; and Turkey, Ordinance on the Procedures and Principles Pertaining to the Implementation of Electronic Signature Law (2005), article 15 (f) and (i).

⁴² Cayman Islands, Electronic Transactions Law, 2000, section 31 (b); China, Electronic Signatures Law, article 15; Thailand, Electronic Transactions Act (2001), section 27, paragraph 2; and Viet Nam, Law on Electronic Transactions, article 25, paragraph 2 (b).

⁴³ China, Electronic Signatures Law, article 27; Dominican Republic, *Ley sobre comercio electrónico, documentos y firmas digitales (2002)*, article 55; Ecuador, *Ley de comercio electrónico, firmas electrónicas y mensajes de datos*, article 17 (e); Panama, *Ley de firma digital (2001)*, article 39; Russian Federation, Federal Law on Electronic Digital Signature (2002), clause 12, paragraph 2; and Venezuela (Bolivarian Republic of), *Ley sobre mensajes de datos y firmas electrónicas*, article 40.

Conclusion

23. Wide use of electronic authentication and signature methods may be a significant step to reduce trade documentation and the related costs in international transactions. While to a very large extent the pace of developments in this area is mainly determined by the quality and security of technological solutions, the law may offer a significant contribution towards facilitating the use of electronic authentication and signature methods.

24. A large number of countries have already taken domestic measures in that direction by adopting legislation that affirms the legal value of electronic communications and sets the criteria for their equivalence to paper-based ones. Provisions regulating electronic authentication and signature methods are often an important component of such laws. The UNCITRAL Model Law on Electronic Commerce⁴⁴ has become the single most influential standard for legislation in this area and its wide implantation has helped to promote an important degree of international harmonization. Wide ratification of the United Nations Convention on the Use of Electronic Communications in International Contracts⁴⁵ would provide even greater harmonization, by offering a particular set of rules for international transactions.

25. International use of electronic authentication and signature methods may also benefit from the adoption of those UNCITRAL standards. In particular, the flexible criteria for functional equivalence between electronic and paper-based signatures contained in the United Nations Convention on the Use of Electronic Communications in International Contracts may provide an international common framework for allowing electronic authentication and signature methods to meet foreign form signature requirements. Nevertheless, some problems may persist, in particular in connection with international use of electronic authentication and signature methods that require the involvement of a trusted third party in the authentication or signature process.

26. The problems that arise in this particular area derive to a very large extent from inconsistency of technical standards or incompatibility of equipment or software, resulting in lack of international interoperability. Efforts to harmonize standards and improve technical compatibility may lead to a solution to the difficulties that exist at present. However, there are also legal difficulties related to use of electronic authentication and signature methods, in particular in connection with domestic laws that either prescribe or favour the use of a particular technology for electronic signatures, typically digital signature technology.

27. Laws that provide for the legal value of digital signatures typically attribute the same legal value to signatures supported by foreign certificates only to the extent that they are regarded as equivalent to domestic certificates. The review done in this study indicates that proper assessment of legal equivalence requires a comparison not only of the technical and security standards attached to a particular signature technology, but also of the rules that would govern the liability of the various parties involved. The UNCITRAL Model Law on Electronic Signatures provides a set of basic common rules governing certain duties of the parties involved in the authentication and signature process that may have an impact on

⁴⁴ See note [...] [United Nations publication, Sales No. E.99.V.4].

⁴⁵ See note [...] [General Assembly resolution 60/21, annex].

their individual liability. There are also regional texts, such as the European Union Directive on electronic signatures, that offer a similar legislative framework for the liability of certification services providers operating in the region. However, neither of those texts addresses all liability issues arising out of the international use of certain electronic authentication and signature methods.

28. It is important for legislators and policymakers to understand the differences between domestic liability regimes and the elements common to them, so as to devise appropriate methods and procedures for recognition of signatures supported by foreign certificates. The domestic laws of various countries may already provide substantially equivalent answers to the various questions discussed in the present reference document, for instance because they share a common legal tradition or belong to a regional integration framework. Such countries may find it useful to devise common liability standards or even harmonize their domestic rules, so as to facilitate cross-border use of electronic authentication and signature methods.

C. Note by the Secretariat on possible future work Indicators of Commercial Fraud

(A/CN.9/624 and Add.1-2) [Original: English]

At its thirty-fifth session in 2002, the Commission first considered whether the problem of fraudulent practices of an international character resulted in a significant adverse economic impact on world commerce and negatively affected legitimate commercial institutions. At its thirty-sixth session in 2003, the Commission considered the note of the Secretariat (A/CN.9/540), and agreed with the recommendation that an international colloquium should be organized to permit an exchange of views from various interested parties regarding the private law aspects of commercial fraud. At its thirty-seventh session in 2004, the Commission considered the report of the UNCITRAL Secretariat on the colloquium (A/CN.9/555), and, *inter alia*, agreed that, with a view towards education, training, and prevention, the preparation of materials setting out common features present in typical fraudulent schemes could be useful as educational material for participants in international trade and other potential targets of perpetrators of fraud, in order to help potential targets protect themselves and avoid becoming victims of fraudulent schemes. It was agreed that the Secretariat should consider preparing, in close consultation with experts, such materials listing common features present in typical fraudulent schemes. The annex attached to this note is the result of that work, and is presented to the Commission for its consideration. Due to the length of the materials, they have been separated into three documents that should be read together: A/CN.9/624; A/CN.9/624/Add.1 and A/CN.9/624/Add.2.

Bearing in mind the full agenda of the current session of the Commission, one possible course of action may be for the Commission to take note of the text and, with any comments it may wish to make, request the Secretariat to disseminate it to Governments and potentially interested institutions, in particular international intergovernmental and non-governmental organizations, with a view to obtaining comments. On the basis of the comments received, the Commission would be able to assess any other action it may wish to take in respect of it.

Annex

UNCITRAL Commercial Fraud Project

RECOGNIZING AND PREVENTING COMMERCIAL FRAUD

Indicators of Commercial Fraud

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I. Introduction

Purpose and Target audience

As early as 2002, the United Nations Commission on International Trade Law (UNCITRAL) first considered the problem of fraudulent practices that resulted in a significant adverse economic impact on world commerce and negatively affected legitimate commercial institutions. Through a series of consultations with experts and government officials who regularly encounter and combat commercial fraud and who represented different regions, perspectives, and disciplines, UNCITRAL became aware of the widespread existence of commercial fraud and its significant worldwide impact, regardless of a country's level of economic development or system of government. In considering possible responses to this threat, it was felt that education and training could play significant roles in fraud prevention, and that the identification of common warning signs and indicators of commercial fraud could be particularly useful in combating fraud.

To this end, the UNCITRAL secretariat met over the ensuing years with international experts and government officials knowledgeable in the identification and prevention of commercial fraud, and as a result developed the attached list of twenty-three indicators of commercial fraud. The overall objective of this project was to assist in the prevention of commercial fraud by creating an easily understood and widely-disseminated document that set out indicators to assist potential victims and their organizations in the identification of behaviour that could be associated with or could constitute commercial fraud. Governments and other bodies and organizations are encouraged to disseminate these materials as widely as possible, and encourage their use in the prevention of fraud.

It is hoped that, in addition to preventing the perpetration of specific commercial frauds through education and awareness, this anti-fraud project will serve three main overarching purposes. First, these materials are intended to identify patterns and characteristics of commercial fraud in a manner that facilitates the private sector in combating commercial fraud in an organized and systematic manner. Second, it is hoped that governmental bodies may be assisted by these materials in understanding how to help the public and private sector to address the problem of commercial fraud. Finally, these materials may assist the criminal law sector in understanding how best to engage the private sector in the battle against commercial fraud.

The intended audience for these materials includes individuals, professionals, business persons, regulators, law enforcement officers, litigants, and potentially arbitration tribunals and courts in cases involving commercial fraud. These materials are not intended as a legislative text nor a legal text, but rather as instructive materials containing useful guidance and reference materials for users. It is hoped that financial decision-makers and those charged with combating commercial fraud can learn and benefit from these materials, be they individual investors or purchasers, CEOs, bank executives, law enforcement agencies or regulators, or the board of directors of any company, large or small. Even decision-makers charged with distributing emergency relief or crisis funds on behalf of governments or international organizations may benefit from recognizing and remaining alert to these potential indicators of fraud. In addition, third parties such as employees of banks or other entities, or professionals assisting in a transaction or an investment, must be aware that they may unwittingly assist in the perpetration of a fraud by simply being blind to the indicators of a potential fraud.

Examination of the various indicators has revealed that they tend to be present in many different cases of potential fraud, regardless of the level of sophistication of the financial decision-maker, or of the development of a particular economy involved. In an effort to illustrate this point, the instances and examples that are given in these materials for each of the indicators are drawn from various different areas of legal practice and include various different types of victims. They are intended to demonstrate that the indicators are meant to be of universal application in a commercial and administrative context, regardless of the identity or role of the potential victim, their net worth, their level of sophistication or their geographic location. The only quality that the victims are certain to share is a vulnerability to fraud that stems from their role as a financial decision maker.

However, it is important to remember that each of the indicators taken alone or in combination is not intended to definitively indicate the presence of commercial fraud. Instead, the presence of a single warning sign is intended to send a signal that

commercial fraud is a possibility, while the presence of several of the indicators should heighten that concern.

The presentation of each of the indicators is similar: first, the indicator is identified, followed by a more detailed description of the indicator, which is in turn followed by instances and examples of the particular indicator as found in a commercial fraud in a variety of different contexts. Advice is then provided regarding what may be done to avoid or to counteract the effects of the behaviour identified in each indicator, as appropriate. Finally, since the identification of discrete indicators is not conducive to a scientific exercise with clear demarcations between them, many of the indicators may or should overlap, and these materials include cross references to other related indicators, where relevant.

History

At its thirty-fifth session in 2002, UNCITRAL first considered whether the problem of fraudulent practices of an international character resulted in a significant adverse economic impact on world commerce and negatively affected legitimate commercial institutions. It was felt that fraudulent practices that affected international commerce had not been sufficiently addressed by international bodies, particularly with respect to their commercial aspects. It was suggested that UNCITRAL was well-positioned to consider the issue of commercial fraud, since it presented the unique combination of a governmental perspective with recognized expertise in international commerce and a tradition of collaboration with other international organizations.¹

In order to assess the extent and implications of commercial fraud and to consider possible recommendations regarding future action, in December 2002, the UNCITRAL Secretariat convened a meeting of experts who regularly encounter and combat commercial fraud and who represented different regions, perspectives, and disciplines. Following that meeting, the UNCITRAL secretariat prepared and issued a note on possible future work relating to commercial fraud (A/CN.9/540) as requested by UNCITRAL at its thirty-fifth session. The note concluded that available evidence suggested that commercial fraud constituted a serious and potentially increasing threat to international commerce. The note also considered factors in defining or describing commercial fraud, concluding that a precise definition was not currently available but that it would be useful to identify and detail common patterns of fraudulent commercial conduct. Finally, the note also suggested that there was an important independent commercial dimension to commercial fraud in addition to that of criminal law enforcement, and made several recommendations to UNCITRAL in regard to future work.

At its thirty-sixth session in 2003, UNCITRAL considered the note of the Secretariat (A/CN.9/540). It agreed with the recommendation that an international colloquium should be organized to permit an exchange of views from various interested parties, including those working in national Governments, intergovernmental organizations and relevant private organizations on the private law aspects of commercial fraud. It was also noted that the colloquium would provide an opportunity to promote an exchange of views with the criminal law and regulatory sectors that combat commercial fraud and to identify matters that could be coordinated or harmonized.²

¹ *Official Records of the General Assembly, Fifty-seventh Session, Supplement No. 17 and corrigendum (A/57/17 and Corr.3)*, paras. 279-290.

² *Ibid.*, *Fifty-eighth Session, Supplement No. 17 (A/58/17)*, paras. 240-241.

A colloquium on international commercial fraud was held in Vienna from 14 to 16 April 2004. The speakers, panellists, and participants at the colloquium consisted of experts from each of several legal practice areas examined, representing as broad a spectrum of approaches to the problem of commercial fraud as possible, and included approximately 120 participants from 30 countries. It was agreed at the colloquium that any doubt had been dispelled as to the widespread existence of commercial fraud and its significant worldwide impact, regardless of a country's economic development or system of government. It was also agreed that education and training played significant roles in fraud prevention and that it would be particularly useful to identify common warning signs and indicators of commercial fraud. In addition, it was agreed at the colloquium that local cooperative efforts between law enforcement bodies and the private sector seemed particularly effective and should be encouraged (see A/CN.9/555, paras. 3, 4, 25-28, and 62-71).

At its thirty-seventh session in 2004, UNCITRAL considered the report of the UNCITRAL secretariat on the colloquium (A/CN.9/555), and, *inter alia*, agreed that, with a view towards education, training, and prevention, the preparation of materials setting out common features present in typical fraudulent schemes could be useful as educational material for participants in international trade and other potential targets of perpetrators of fraud. It was thought that such materials would help potential targets protect themselves and avoid becoming victims of fraudulent schemes. Further, it was thought that national and international organizations interested in fighting commercial fraud could be invited to circulate such material among their members in order to help test and improve those lists. While it was not proposed that UNCITRAL itself or its intergovernmental working groups be directly involved in that activity, it was agreed that the UNCITRAL Secretariat should consider preparing, in close consultation with experts, such materials listing common features present in typical fraudulent schemes.³

At its thirty-eighth session in 2005, UNCITRAL reiterated its support for this project,⁴ and at its thirty-ninth session in 2006, UNCITRAL further approved of the general approach taken in the drafting of these materials as set out in a note by the Secretariat (A/CN.9/600).⁵

For further information, please visit the UNCITRAL website at www.uncitral.org.

II. What is Commercial Fraud?

It would not be appropriate to set out a strictly legal definition of commercial fraud in light of the aims and objectives of these materials, nor would such a definition allow sufficient flexibility for the intended broad use of those materials. However, a descriptive definition outlining the main elements of commercial fraud could be helpful to the user of these materials.

The following elements are key to the identification of commercial fraud:

- (1) There is an element of deceit or of providing inaccurate, incomplete or misleading information;

³ Ibid., *Fifty-ninth Session, Supplement No. 17* (A/59/17), paras. 110-112.

⁴ Ibid., *Sixtieth Session, Supplement No. 17* (A/60/17), para. 220.

⁵ Ibid., *Sixty-first Session, Supplement No. 17* (A/61/17), para. 217.

- (2) Reliance on the deceit or the information provided or omitted induces the target of the fraud to part with some valuable thing that belongs to the target or to surrender a legal right;
- (3) There is a serious economic dimension and scale to the fraud;
- (4) The fraud uses or misuses and compromises or distorts commercial systems and their legitimate instruments, potentially creating an international impact; and
- (5) There is a resultant loss of value.

Further, the term “fraudster” has been used in these materials as a term to identify someone who is perpetrating, or attempting to perpetrate a fraud.

III. Related Topics

A number of serious issues related to commercial fraud have not been covered in these materials in order to keep them of a manageable and useful size, and since such issues have been, and are continuing to be, dealt with in other forums or by other organizations. A non-exhaustive list of such issues, and some suggestions regarding where further information can be found, appears below. Note also that the suggested sources for further information are limited to international organizations, and that there are numerous national governmental and non-governmental organizations which have also worked extensively in these areas, and to which resort should be had for more information.

A. Corruption and Bribery

Corruption has been defined by Transparency International as “the misuse of entrusted power for private gain”. Further differentiation has been made between “according to the rule corruption” and “against the rule corruption”, wherein the former includes facilitation payments, where a bribe is paid to receive preferential treatment for something that the receiver of the bribe is required to do by law, while the latter includes bribes to obtain services that the receiver of the bribe is prohibited from providing.

A number of international organizations have adopted instruments, including conventions, aimed at fighting corruption and bribery. These organizations include: the United Nations; the African Union; the Council of Europe; the European Union; the Economic Community of West African States; the Organization of American States; and the Organisation for Economic Cooperation and Development.

There is a large amount of information available concerning corruption and bribery, including materials on how to combat it. The following lists a few of the many sources of such information:

- Transparency International; www.transparency.org
- United Nations Office on Drugs and Crime; www.unodc.org
- Organisation for Economic Cooperation and Development; www.oecd.org
- Organization of American States; www.oas.org
- The World Bank; www.worldbank.org

B. Money-Laundering

Money-laundering may be described as the practice of engaging in specific financial transactions in order to conceal the identity, course, and/or the destination of money. A number of national and international rules and programmes have been developed to combat money-laundering.

Again, there is a great deal of information available on money-laundering, both nationally and internationally. For example, resort may be had to:

- Financial Action Task Force; www.fatf-gafi.org
- International Bar Association Anti-Money-Laundering Forum; www.anti-moneylaundering.org

C. Transparency

“Transparency” has been defined, again by Transparency International on their website, as “a principle that allow those affected by administrative decisions, business transactions or charitable work to know not only the basic facts and figures, but also the mechanisms and processes” by means of which the decisions were made and transactions entered into. It is further said that “it is the duty of civil servants, managers and trustees to act visibly, predictably and understandably”.

As a general principle, true transparency should be sought in all transactions and if achieved, should result in the prevention and avoidance of commercial fraud.

For further information, one source that may be consulted is:

- Transparency International; www.transparency.org

D. Best Practices

“Best practices” are, in this case, those techniques, methods, processes, activities or the like, used by highly respected organizations, public and private, that are focused on the prevention or detection of commercial fraud, and that should be adopted by entities such as companies and financial institutions and consistently followed by their employees. If such approaches are followed, and the proper processes, checks and testing have taken place, those systems should assist greatly in the prevention or detection of a fraud. Entities and organizations should be sure to investigate and adopt the best practices most suited to their operations, and should investigate them by way of their professional organizations or consult with private sector specialists.

(1) Corporate Governance

The term “corporate governance” is the set of processes, laws, policies and institutions affecting the way a corporation is directed, administered and controlled, and involves the set of relationships between the company’s management, its board of directors, its shareholders and other stakeholders. At the core of corporate governance are issues such as corporate fairness, transparency, fiduciary duty and accountability.

Establishing and adhering to the principles of good corporate governance should assist greatly in the prevention of commercial fraud either on the company, or on other parties, with the assistance of employees.

A great deal of material has been published on this topic, and resort could be had to the following sources:

- Organisation for Economic Cooperation and Development; www.oecd.org

(2) Whistleblower policies

A “whistleblower” is someone, usually an insider, who reveals wrongdoing within an organization to the public or to those in positions of authority. Whistleblowing policies operate to give adequate protection to those who wish to come forward to report deviations from legal or ethical corporate standards. This can be done, for example, via confidential telephone services or intranet sites through which employees and business partners can address concerns or pass information. To make such services effective, genuine concerns must be listened to and acted upon in a timely manner by the responsible board committee.

The adoption of adequate whistleblower policies by an organization, and education of employees about the existence and anonymity of such processes, can aid greatly in the detection of fraud or wrongdoing within an organization.

Again, much has been written on this topic, for example by:

- Transparency International; www.transparency.org

(3) Role of Internal and External Auditors

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes. Internal auditors are employees of the entity who report to a general or chief auditor, who, in turn, reports to the Audit Committee of the Board of Directors.

An external auditor consists of audit professionals who perform an audit on the financial statements of a company, individual or other organization, its key characteristic being that it is independent from the entity being audited. The external auditor also reports to the Board of Directors of an organization, and may also be required by specific legislation to make submissions to regulatory agencies.

Both types of audits are useful and recommended to detect fraudulent activity and to assist in its prevention.

Again, reference may be had to:

- Transparency International; www.transparency.org
- Organisation for Economic Cooperation and Development; www.oecd.org

Indicators of Commercial Fraud

Indicator 1 Irregular Documents

Indicator 2 Misuse of Technical Terms

Indicator 3	Inconsistencies in the Transaction
Indicator 4	Misuse of Names
Indicator 5	Disproportionate Returns
Indicator 6	Undue Secrecy
Indicator 7	Overly Complex or Overly Simplistic Transactions
Indicator 8	Frustration of Due Diligence
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Indicator 17	Unusual Involvement or Participation of Professionals
Indicator 18	Inappropriate Requests for Information Disclosure
Indicator 19	Unsolicited E-mails and Related Misuse of Technology
Indicator 20	Pyramid and Multi-Level Marketing Schemes
Indicator 21	Frauds involving Goods and Services
Indicator 22	Securities Fraud and Market Abuse
Indicator 23	Misuse of Insolvency Proceedings

Indicator 1: Irregular Documents

Commercial frauds almost always involve the issuance of, use of, or reliance on documents that are not normally or typically used in the type of transaction to which they are intended to relate, or on documents that contain discernable irregularities either individually, or when read in light of all the documents presented in support of the scheme.

Explanation:

Commercial frauds, like legitimate transactions, involve the use of multiple documents to explain, memorialize, and reflect the transaction. However, the documents used in commercial frauds often differ from those used in legitimate transactions either because they are improperly drafted, or because they contain some unusual features to induce investment, to bolster the fraudster's credibility, to explain the extraordinary returns claimed by the fraudster, or they set out unusual procedures. It is often possible to determine the likelihood or presence of a commercial fraud by identifying these irregular aspects. Documents used in support of a commercial fraud can be genuine, fraudulent, forged, or fictitious, and can be

issued or authenticated either properly or improperly by institutions or individuals. Sometimes professionals can be involved in their creation or authentication.

Instances and Examples:

- Documents that may be used in connection with commercial frauds include:

- Genuine documents;

Illustration 1-1: Such documents may include: studies by organizations; letters of introduction; written attestations that an individual has an account in the institution or is a customer of the institution; a contract drafted by a lawyer; an authenticated telecommunication or funds transfer or SWIFT.

- Fictitious documents that are not used in legitimate commerce;

Illustration 1-2: Such documents may include: an “irrevocable SWIFT”; “UCP500 Forfait Transaction” or “Grain Warrants”.

- Forged or fraudulent documents;

Illustration 1-3: An employee forges the signature of a bank manager on a letter provided by the fraudster.

Illustration 1-4: Documents that are commonly forged or fraudulent may include a forged signature or misdescription of goods on a bill of lading; a bank guarantee; documents under a commercial letter of credit; or false audit reports.

- Counterfeits of genuine documents.

Illustration 1-5: Documents that are commonly counterfeited include stock certificates; debentures; promissory notes; precious metal depositary certificates; warehouse certificates; or government procurement contracts, all of which may be used to induce investment in a fraudulent investment scheme or hypothecated to obtain an extension of credit from a legitimate financial institution.

- Legitimate institutions or their employees can be knowingly or unwittingly induced to issue or verify legitimate or illegitimate documents that are then used to enhance the fraudulent scheme. Electronic verification may also be requested.

Illustration 1-6: A clerk is asked to issue or authenticate a document that is not usually issued by that clerk or by that institution. Or, the requester of the document seeks the inclusion of unusual phrases such as that funds are of “non-criminal origin”, or may request the insertion of legitimate commercial terms such as that the customer is “ready, willing, and able” to enter into transaction. The clerk obliges in order to assist the customer but without understanding the document or phrases, and the documents are subsequently used to bolster the credibility of the fraud.

Illustration 1-7: A clerk authenticates a document prepared by a customer on bank or company stationery. Although the clerk intends only to authenticate the signature or identity of the

customer, the document contains statements that are used to enhance credibility by indicating that the bank or company attests to what is said in the document.

- The irregularities in documents used in commercial fraud may be caused by or connected with professionals.

Illustration 1-8: A lawyer, accountant or other professional prepares documents at the request of a client regarding a transaction that the professional does not inquire into or does not understand, and that does not make economic or other sense. The fraudster often needs the professional to give credibility to his or her scheme. Agreeing to witness or confirm a pre-signed document would be a particular example of a transaction that could facilitate a fraud.

- A commercial fraud may be signalled by:

- An absence of proper documentation;

Illustration 1-9: The existence of only a few poorly drafted documents for a major transaction; or a bank loan without a business plan to repay money.

- Documents that are issued by a genuine commercial entity but contain irregularities in connection with their issuance;

Illustration 1-10: A shipping clerk is asked to sign and postdate a document stating that goods, which have not yet arrived, have been received on the basis of the presenter's representation that goods will be received by that date. The presenter then uses the document to obtain payment, although goods are never delivered.

Illustration 1-11: A seller of real or personal property is asked to adjust the stated purchase price for real or personal property so that the buyer may increase the amount able to be borrowed or to decrease tax liability for the transaction or the property.

- Internal irregularities and inconsistencies in the documents;

Illustration 1-12: A document relating to a sophisticated transaction or one for a large sum contains spelling errors or grammatical errors, or has unprofessional-looking graphics or an unsophisticated appearance.

Illustration 1-13: Odd phrases or terms found in genuine documents, including: "NC/ND"; a document that is not a letter of credit is said to be subject to UCP500; performance in a "year and a day" or "a month and a day"; reference to "international banking seconds, hours or days".

Illustration 1-14: A transaction for a large amount of money that is disproportionate with the situation or the person with which it is connected, such as a small bank with assets of UK £75 million issuing a document for UK £100 million.

- The presence of a document that does not itself make sense or that does not make sense in connection with other documents involved in the transaction;

Illustration 1-15: In a transaction allegedly involving the sale of independent guarantees, a document was presented relating to factoring.

- The presence of incorrect or unusual headings of or in documents;

Illustration 1-16: What is supposed to be a letter of credit is entitled “Hypothecation Agreement” and contains a promise to pay funds to bearer.

- Documents that do not appear in the normal course of business;
- The unusual appearance or texture of a financial instrument;

Illustration 1-17: Document contains blurred typography, poor paper quality, spelling mistakes or an unprofessional look or graphics.

- The antedating or postdating of documents;

Illustration 1-18: A bill of lading stating that the goods are loaded on board a vessel is issued with a date a week earlier than the date the goods are said to have been loaded.

- Or changes in the existing documentation that fundamentally and inexplicably change the nature of the transaction.

Illustration 1-19: The transaction is said to relate to trading in sugar and, purportedly as a result of a difficulty, the documents are suddenly switched to relate to a sale of steel.

Illustration 1-20: The documentation was an independent guarantee and it is suddenly a promissory note.

Advice:

- Complete documentation of the investment should be required in advance and any unusual characteristics or aspects that are not understood in the form, content, or authenticity of the documents should be investigated, especially where the investment involves financial instruments.
- Read carefully documents presented in support of an investment and remember that they should be consistent in terms of the transaction as a whole.
- Documents should not be antedated or postdated, and the dates referred to in them should be consistent.
- Documents presented in support of a proposed commercial transaction should not be relied upon without considering their content, purpose and source.
- Inquire whether the document is of a type that is regularly issued.
- A general addressee, such as “To whom it may concern” should be cause for further inquiry.
- Do not assume the authenticity of letterheads of well-known companies or organizations that could have been produced by laser printer.

- Verify signatures.
- Determine that professionals employed have an understanding of the documents they are preparing or verifying.
- Perform thorough due diligence by consulting independent sources of information, or by consulting legal and risk management or security departments regarding the documents and their contents.
- If critical reliance in a transaction is placed on a particular document, it should be produced.
- Extreme caution should be exercised if engaging in a transaction where irregular or incomplete documents are used or relied upon as a matter of course in the trade.
- Never grant power of attorney to persons unknown.
- Do not sign, issue or authenticate documents that are unusual, that are not understood, that are not usually signed by the individual or institution being requested to sign them, or whose purpose is not understood.
- Do not sign a document that is incomplete or that is in another language that is not understood.
- Never sign or issue a statement that is known or suspected to be untrue.
- Investigate whether the person requesting the service is a regular customer.
- It may be advisable to set out the purpose for which the document was prepared in the body of the document itself, as a means to possibly avoid later misuse.
- Be cautious of issuing unusual documents, particularly when the text is provided by the requester.
- Use forms that are approved by legal and risk management or security departments.
- If presented with a financial instrument that is unfamiliar in the marketplace, such as a stock certificate traded on a foreign exchange, have the document examined by a reputable expert in the field, like a stockbroker of good reputation.

See also: Indicator 3 — Inconsistencies in the Transaction; Indicator 4 — Misuse of Names; Indicator 6 — Undue Secrecy; Indicator 8 — Frustration of Due Diligence; and Indicator 17 — Unusual Involvement or Participation of Professionals; Addendum 1 — Performing Due Diligence.

Indicator 2: Misuse of Technical Terms

Commercial frauds misuse technical terms by using an actual term in an incorrect context or inventing an impressive sounding term to gain credibility, to obscure implausible aspects of the scheme, or to impress or intimidate victims or their advisors.

Explanation:

Modern commerce and finance are complex and regularly use specialized terms related to a transaction or its financing. Commercial frauds frequently employ such terms to give the impression that the scheme is genuine, to impress or intimidate victims, or to cover their inability to explain inconsistencies or illegal aspects of the transaction. Since the fraudsters are often not knowledgeable themselves, they often misuse specialized terms, thereby signalling that the transaction is not genuine. Legitimate transactions occasionally may contain mistakes that are not essential to the transaction, and where a misuse is infrequent or the mistake is peripheral to the nature of the scheme, it is less likely to indicate commercial fraud. However, where the misuse is of a term essential to the scheme, and where it is consistent and frequent, it may indicate that the transaction is not legitimate.

Instances and Examples:

- Technical terms can be misused to:
 - Impress or overwhelm the victim;

Illustration 2-1: Fraudster gives a detailed but distorted discussion of macroeconomic history oriented towards reinforcing the credibility of the investment.

Illustration 2-2: Fraudster makes reference to major international agreements or programmes such as the Bretton Woods Agreements or the Marshall Plan to explain the overall scheme.
 - Justify the inexplicable by resort to technical terminology;

Illustration 2-3: Funds in an account are said not be to at risk because they will be “scanned” by the trading bank, but not otherwise affected.
 - Excuse a failure in promised performance;

Illustration 2-4: Government regulations, such as tax laws, or electronic funds transfer systems rules are referred to in explaining why the “trades” or payment is delayed, or why additional funds are required by the fraudster.
 - Or build excessive reliance by the victim on the fraudster’s apparently superior knowledge.

Illustration 2-5: Fraudster rationalizes the disproportionate returns of the scheme based on an economic analysis that explains how banks purportedly increase the money supply.
- Misused technical terms may either exist and be used properly, may be used incorrectly or in an improper context, or may be entirely fictional.

Illustration 2-6: Actual terms such as “Factoring” or “Forfait” may be used incorrectly.

Illustration 2-7: Investment is said to involve trading in independent guarantees that do exist but are not “traded”.

Illustration 2-8: Investment is said to be made on a specific form, such as “ICC Form 1020”, but the form does not exist.

Illustration 2-9: Fraudster misuses or twists legitimate technical or scientific terms, such as a successful fraud in the oil and gas industry that referred to the fictional process of “sonic” fracturing to assist oil or gas recovery.

- Technical terms may also be misused in different ways:

- At different stages of the scheme;

Illustration 2-10: For example, they may be used to entice the investor, to obtain funds, to induce the transfer of control of assets, to explain why payments are delayed, or to prevent the investor from contacting authorities.

- Or beyond their intended purpose in order to validate a transaction.

Illustration 2-11: Commercial frauds often use technical terms regarding funds transfer to purportedly indicate the legitimacy of the transaction, but which are in fact only intended to indicate that a particular message was sent, but do not authenticate its contents.

Advice:

- Do not be intimidated or impressed by the use of technical terms and jargon.
- Insist on a clear explanation, regardless of the level of one’s own knowledge or expertise.
- Understand all aspects of the transaction before investing.
- When performing due diligence, do not simply be satisfied with the existence of a specific technical term, such as “stand-by letters of credit”, but ascertain whether the technical term or its role in the transaction is used properly in the context.
- Check into the existence and operation of any law under which taxes, fees and other sums are allegedly owed.
- Employees should be educated about commonly misused terms and phrases.
- The appropriate employee within an organization should be consulted on a specialized transaction, or should be part of the negotiating or document review team.

See also: Indicator 6 — Undue Secrecy; Indicator 8 — Frustration of Due Diligence; Addendum 1 — Performing Due Diligence.

Indicator 3: Inconsistencies in the Transaction

In attempting to mimic aspects of genuine transactions, commercial frauds often contain untrue or conflicting statements of material facts, omissions of material facts and other serious inconsistencies.

Explanation:

Commercial transactions operate under rule-based systems; multiple aspects, documents, details, and representations are consistent with one another and, taken as a whole, reflect the scope and purpose of the transaction. Any inconsistency or repeated inconsistencies that do not result from an agreed change in the transaction are removed in the case of legitimate commercial transactions. Transaction participants understand the representations and details and ensure that all aspects of the entire context of the transaction are consistent. On this basis they may with confidence accept transactional and contractual obligations.

In a sophisticated fraud, inconsistencies may not be obvious, such as in the case of frauds where professionals within seemingly reputable firms of lawyers, accountants and bankers may have been successfully misled by a fraudster, and have unwittingly assisted in creating fraudulent documentation. However, in a typical scheme, fraudsters are unlikely to concern themselves with transactional realities in their quest to find a potential victim. In fact, fraudsters may create inconsistencies intentionally, with the expectation that the more informed persons will walk away, leaving only those potential victims who are most vulnerable. Further, fraudsters are not necessarily concerned that all aspects of the context of the transaction be consistent. They often use old, pattern frauds, developed by others decades ago, and simply adapt these old schemes to the Internet, or replace old names with invented modern sounding fictitious instruments, such as “Anti-Terrorism/Drug Free Certificates” and may not know of the fraud’s internal inconsistencies. Fraudsters often are not experts in the fields of investment or business contemplated by their frauds and, lacking such expertise, they inadvertently may create inconsistencies in the transaction within individual documents or between documents, or there may be inconsistencies between what is written and what is said on various occasions.

Instances and Examples:

- The nature of goods changes depending on the document examined.

Illustration 3-1: At the outset, a transaction involves shipments of one commodity, but without any commercial explanation, the goods being sold are described as a different commodity in later documentation.

- What is written or said is devoid of logic or common sense.

Illustration 3-2: The goods described in the transaction, or a financial instrument described in the transaction, do not exist or are not commercially traded.

Illustration 3-3: An invoice reflects ocean carriage, but the transport document reflects rail or truck transport only.

Illustration 3-4: The first document refers to “ABC Corp” while later documents refer to “XYZ Corp”, or one company may guarantee the first document, while another guarantees the second document.

Illustration 3-5: Container or seal numbers listed on bills of lading or other transport documents are suspicious, or do not reflect the proper numbering and lettering systems.

- Individual orders are out of context with the overall transactional history.

Illustration 3-6: An unusual quantity of the same product is ordered with a demand for next-day delivery to be shipped to a mail-drop address.

Advice:

- Read documents critically, take detailed notes of any oral representations, and require any oral representations to be incorporated into the documents.
- Do not rely solely on the documents presented for due diligence.
- Ask questions about inconsistencies and do not accept facile answers or excuses. Suspicious or illogical explanations when inconsistencies are raised may signal fraud.
- The presence of inconsistencies is unusual; the unresolved presence of inconsistencies is highly unusual; and both may signal fraud.
- If a transaction or activity occurs that does not pass one's own "common sense" test, then that alone is a good enough basis to consider the matter suspicious and to pursue due diligence.

See also: Indicator 1 — Irregular Documents; Indicator 8 — Frustration of Due Diligence; Indicator 14 — Irrational or Illogical Aspects or Explanations; Indicator 21 — Frauds involving Goods and Services; Addendum 1 — Performing Due Diligence.

Indicator 4: Misuse of Names

The person promoting a fraudulent scheme often seeks to enhance personal credibility or that of the scheme by associating it with the names of persons or organizations known, or likely to be known, by the person or entity to which the scheme is presented.

Explanation:

Names, particularly of those who are reputable or influential in the field, are misused in several ways in commercial frauds. Similarly, the names, logos, trademarks, catch-phrases, and symbols of a company or other entity, can be used in the perpetration of a fraud. A fraudster may suggest that individuals known within the field have reviewed and approved of the purported transaction, thus suggesting to the victim credibility, validity and enforceability of the fraudulent scheme. A fraudster may introduce or promote a scheme by asserting a false or exaggerated relationship with a person or entity known to the victim or its advisors. A fraudster may give the name of a well-known person or entity as his or her own or suggest an association with it, or a fraudster may simply adopt the name of another person or entity to hide the fraudster's own identity.

Instances and Examples:

- The names used in connection with commercial fraud may be of:
 - Well-known persons or organizations;

Illustration 4-1: A fraudster claims to be a protégé of the head of a country's Central Bank or Ministry or similar body, who is alleged to have provided advice regarding the scheme, but whose role and/or identity is not revealed.

Illustration 4-2: The fraudster introduces the potential victim to an actual or purported relative of an eminent person, such as the prime minister or a president of a country, who is willing to vouch for the fraudster or his or her proposed transaction.

- Individuals with whom the potential victim or the victim's advisors are familiar;

Illustration 4-3: The fraudster claims that the potential victim's business partner or friend has participated in the transaction when, in fact, that person has not.

- Or well-known organizations and rules.

Illustration 4-4: Documentation provided by the fraudster mentions the United Nations, or the International Monetary Fund or the International Chamber of Commerce, but gives no explanation as to its relationship to the transaction. Other references may be to ICC Rules, UCP 500, or SWIFT when the nature of the transaction does not correspond with the rules cited, or, more generally, to the involvement or approval of other "federal" or "national" or international banking or other authorities.

- A commercial fraud may be signalled where:

- The promoter of the transaction gives instructions concerning individuals or entities that the potential victim may wish to contact to verify the authenticity of the transaction:

Illustration 4-5: The fraudster suggests that an international or governmental entity approves of transactions of the type promoted. However, the fraudster warns the potential victim that if he or she contacts that body to ask about the transaction, the entity will be forced to deny the legitimacy of the transaction.

Illustration 4-6: The fraudster suggests that the president of a major bank has approved of the fraudster's transaction and suggests that the potential victim contact the president to discuss the transaction, even providing the president's telephone number and email address. However, the potential victim's inquiries are in fact answered by the fraudster or a co-conspirator, who assures the potential victim of the legitimacy of the transaction.

- The potential victim cannot verify that the references made by the fraudster actually support the transaction:

Illustration 4-7: The fraudster states that a well-known celebrity or sports figure has invested in the fraudster's purported transaction. Because the victim cannot contact the celebrity directly to discuss financial transactions, the reference cannot be verified.

- Or telephone numbers given to verify information are mobile telephone numbers, or do not correspond geographically with the address given.

Advice:

- An independent investigation of claims of affiliation should be conducted. Most well-known organizations have public information against which claims and documents can be compared for substantiation. However, note that elaborate schemes may involve the creation of false websites that mirror the authentic website of an organization, which may provide false information about the scheme.
- A solid investment opportunity should stand on its own merits and not rely on purported associations with well-known persons or entities.
- Do not rely upon or make assumptions about the use of names and reputations of alleged backers or prior investors without further inquiry and investigation.
- In countries or situations where it is difficult to investigate secret personal relationships with powerful people and organizations, extreme caution should be used by a prospective investor.
- Do not rely on a business card as a means of identification of the individuals with whom one is dealing.
- Professional intermediaries must also be aware of the dangers of relying on the use of names without an independent investigation.
- Organizations should actively and publicly defend their name and expose any improper use of it and should make publicly clear the organization's legitimate functions.

See also: Indicator 1 — Irregular Documents; Indicator 6 — Undue Secrecy; Indicator 8 — Frustration of Due Diligence; Indicator 10 — Ensnarement and Psychological Inducements; Indicator 15 — Fraud Based on Abuse of Personal Affinity or Relationships; Indicator 17 — Unusual Involvement or Participation of Professionals; Addendum 1 — Performing Due Diligence.

Indicator 5: Disproportionate Returns

Commercial frauds often guarantee high yields with little or no risk.

Explanation:

Every investor wishes to maximize returns. However, it must be remembered that returns are always proportionate to the perceived risk, which varies amongst investments. When the risk is high, investors require higher returns than they would receive from less risky investments before placing their capital at risk. Therefore, the higher the risk, the greater the promised return. Commercial frauds distort this principle of proportionality, promising high returns for little or no risk in order to induce investments. Often promised returns are even far in excess of what could be earned from highly speculative investments. The risk-free character of the proposed investment is emphasized using a variety of means, including promises or guarantees from the fraudster or from third parties or entities. Some fraudulent

schemes purport to provide evidence that the returns are being earned or they may even actually pay such returns from the money originally invested or from money invested by other investors.

Instances and Examples:

- Commercial frauds promise:

- Low risk;

Illustration 5-1: The literature in support of the investment provides assurances that the principal or principal and earnings are “risk free” or “without risk”.

Illustration 5-2: The funds are said to be in an account that is under the control of the investor and that the funds will not be moved without the investor’s permission.

Illustration 5-3: The funds are said to be placed in an escrow account of a professional such as an attorney, which is intended to provide added confidence as to the safety of the investment and the funds. However, the professional may be deliberately assisting in the fraud or may be under the instruction of the fraudster rather than of the person depositing the funds.

Illustration 5-4: Phrases such as “riskless principal” are used out of context.

- Guarantees are made or given;

Illustration 5-5: The fraudster provides a personal guarantee or one from an accomplice, but such a guarantee is worthless.

Illustration 5-6: The fraudster promises a guarantee from a major bank or financial institution which will be provided when the investment is made.

Illustration 5-7: The fraudster indicates that the funds or investment are insured.

Illustration 5-8: The fraudster asserts that the funds are guaranteed by a governmental or international agency or organization.

- Or disproportionately high returns.

Illustration 5-9: The returns promised frequently range from 20 per cent per month to 50 per cent per month in a low inflation currency.

- The disproportionately high returns are explained in a variety of ways.

Illustration 5-10: High returns are justified by the volume of “trading” in which small profits per trade are accumulated. Usually the mathematics supporting these figures is flawed: the calculation may fail to take into account expenses, or may suggest more trades than typically take place in the given investment.

Illustration 5-11: Sales and market data are often manipulated, especially with respect to the time frame, to make it seem that returns are very high over a very short period of time.

- Note: Even the actual payment of promised high returns does not ensure the legitimacy of the investment.

Illustration 5-12: Alleged returns may be paid from the investor's own money or that of other investors and not from any real return on the investment.

Illustration 5-13: Such high returns often appear only as bookkeeping entries and investors are encouraged to "reinvest" by the promise of even higher returns.

Advice:

- If an investment scheme sounds too good to be true, it probably is not genuine.
- Perform due diligence by understanding the nature of the investment, its likely and possible risks and returns or consulting with an independent person who may be relied upon to provide appropriate advice.
- Beware of confidence builders, i.e. small, insignificant transactions which appear effective and offer suitable returns aimed at inducing further and more substantial investment.
- Excessive emphasis by a promoter on rate of return, or that an investment is "no risk" or "low risk" or "high return", with little or no discussion of the substance of the investment should be a cause for concern.
- The returns promised are completely out of proportion to the risk assumed and to prevailing market rates of returns.

See also: Indicator 8 — Frustration of Due Diligence; Indicator 9 — Corrupted Incentives; Indicator 13 — Questionable or Unknown Source of Repayment; Indicator 15 — Fraud Based on Abuse of Personal Affinity or Relationships; Indicator 20 — Pyramid and Multi-level Marketing Schemes; Addendum 1 — Performing Due Diligence.

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Indicator 6: Undue Secrecy

Commercial frauds frequently seek to impose undue secrecy and confidentiality on a number of issues including the existence of the opportunity to invest, the nature of the investment, the investment mechanisms and the source of return.

Explanation:

Transparency is critical to the functioning of modern financial markets and information about these markets and investments is widely available. On the other hand, investors do engage in investments based on confidential information or information whose significance is not widely understood. In some situations, acting on such information can be illegal. In other commercial activities, companies legitimately seek to prevent disclosure of confidential information or industrial techniques by employees or others by various legal devices in order to remain competitive in an industry. Such restrictions however, are almost never appropriate with respect to investors and particularly not with regard to the means by which funds are to be generated. Undue secrecy is a level of secrecy that goes beyond that which is appropriate to the transaction.

The requirement of secrecy may be set out in rules or requirements, often coupled with “legal sanctions” purporting to make investors liable for damages should they disclose any information, in order to suggest that the financial decision maker would be implicated, should the transaction be revealed. Such secrecy is intended to obscure the transaction, to inhibit the exercise of due diligence and to prevent investors from contacting advisors or appropriate sources of information that might assist the investor in avoiding the fraud.

Instances and Examples:

- Multiple excuses are given to justify undue secrecy.

Illustration 6-1: Frequently, it is claimed that consulting with knowledgeable persons or organizations disrupts the business transaction, interferes with the deal somehow, and ruins the opportunity for profits.

Illustration 6-2: Claims are often made that banks, stock markets, CEOs, professionals, or prominent persons engage in the type of investment at issue on a regular basis, but secretly, in order to prevent the public from gaining a similar financial advantage.

Illustration 6-3: It is often claimed that the laws of off-shore jurisdictions that are somehow connected to the investment require such secrecy.

- During the course of the transaction, victims are often warned against contacting the police, regulators, or other officials.

Illustration 6-4: It is often stated that the involvement of regulators will cause the transaction to be frozen, delayed, or jeopardized, placing the onus on the victim.

- The term “Non-Circumvention or Non-Disclosure” is frequently used in connection with attempts at secrecy. Such provisions are used in businesses where there is a middleman linking buyer and seller, but are completely inappropriate or of concern with respect to ordinary investments.

Illustration 6-5: Victims are required to sign a detailed ICC (International Chamber of Commerce) Non-Circumvention and Non-Disclosure Agreement that, if taken at face value, would prevent them from discussing the investment with their accountant, attorney, or financial advisor.

- Confidentiality or secrecy is often given as an excuse for the lack of public information about the investment.

Illustration 6-6: Illogical claims that allegedly prove the genuine nature of the transactions, such as that the United States Federal Reserve chairman knows about this type of transaction, but if asked about it, he would deny it.

- Sources of concern include the following in a financial as opposed to a commercial transaction:

Illustration 6-7: Repeated insistence on absolute secrecy.

Illustration 6-8: investors are required to sign agreements with disproportionately serious sanctions should they disclose information.

Advice:

- Investors should discuss the proposed transaction with a competent professional advisor.

- An investor should ask whether there is any commercial imperative for the secrecy or whether the secrecy is unrelated to the core concept of the investment.
- An investor should not be intimidated by the suggestion that liability will result from revealing aspects of the transaction to financial advisors.
- An investor should remember that legitimate confidentiality agreements do not prevent or forbid either the performance of due diligence on the transaction, or the contacting of authorities.
- An investor should not participate in investments when funds are moved off-shore unless complete and detailed information on the transaction is available in order to ascertain where money is flowing and whether movement of funds to that jurisdiction could be improper.

See also: Indicator 1 — Irregular Documents; Indicator 2 — Misuse of Technical Terms; Indicator 4 — Misuse of Names; Indicator 8 — Due Diligence; Indicator 9 — Corrupted Incentives; Indicator 10 — Ensnarement and Psychological Inducements; Indicator 12 — Immediate, Fast or Irrevocable Transfer of Funds; Addendum 1 — Performing Due Diligence.

Indicator 7: Overly Complex or Overly Simplistic Transactions

Commercial frauds are often designed to be overly complex in an attempt to obscure the fundamentals of the transaction, and may include illogical representations as well as convoluted, circuitous or impenetrable documentation. On the other hand, some commercial frauds may also be unduly simplistic or informal, with very little documentation or explanation, despite their apparent connection with a sophisticated or complex financial transaction.

Explanation:

Although commercial transactions, particularly international commercial transactions, may at times be complex by their very nature, the person being asked to make a decision with financial implications should have at least a basic understanding of the transaction in which participation is being solicited. Fraudsters often use as a model legitimate transactions that are highly complex and therefore marketed only to very sophisticated investors. This model is then used by the fraudster to involve less sophisticated individuals who may not be capable of understanding the nature of the transaction or the necessity of the complexity. Further, a web of companies or other entities may be created in order to distance the fraudster from blame when the fraud is discovered, to frustrate asset recovery, to launder the proceeds of crime, or to enable the fraudster to continue to operate a series of parallel schemes. Artificial or unnecessary complexity and absurd oversimplifications are two techniques that fraudsters use to obfuscate the fundamentals of the transaction, which, typically, make no economic sense.

Instances and Examples:

- Inordinately complex business structures that create a façade for multiple companies with no apparent role or reason are designed to make it difficult to hold fraudsters accountable.

Illustration 7-1: Six individuals formed a number of corporations and companies under the umbrella of a “programme of empowerment” and “wealth enhancement” network, conducting large workshops to entice unsophisticated investors into investments in foreign currency that they falsely described as highly profitable and “low risk”.

- Very little documentation may be associated with an unduly simplistic or informal transaction that would ordinarily require significant documentation.

Illustration 7-2: Homeowners in imminent risk of foreclosure were persuaded to sign a simple form to “temporarily” transfer ownership of their homes to “straw buyers”. The straw buyers then applied for mortgages on the homes using phoney credit histories. After draining the equity, the loans were defaulted upon, subjecting the owners to threats of eviction. The financial institutions recovered little.

Illustration 7-3: The presence of highly informal text in the documents, for example, the use of a phrase such as “telephone at the usual number”, may signal the presence of a commercial fraud.

- Complexity compounds problems related to tracking payments and disbursements and recovering funds.

Illustration 7-4: Frequently, fraudsters use multiple layers of business entities to conduct multiple transfers of funds and/or frequent changes of depository banks. Since transnational fraud schemes also often use Internet-based funds transfer mechanisms rather than conventional banking channels, such funds are extremely difficult to trace.

- Technology, including transportation, information and communication technology, is increasingly being used to inject complexity in order to avoid detection and to conceal proceeds.

Advice:

- Be aware that there may be commercial fraud when there is no explanation and no apparent commercial purpose for complexities in the transaction, where intricacies appear artificial, where there appear to be parties with no meaningful role, or where the number of transactions or transfers or the structure of the transaction make it difficult to investigate it.
- Ensure that the purpose of each element of the transaction is understood. Do not be afraid to ask questions, even though it is possible that the answers might be obvious.
- Legitimate transactions may be complex, but, if so, they require informed counterparties using independent advice from knowledgeable sources.
- If details cannot be provided immediately, it should not deter the investor from obtaining the details from elsewhere prior to investing.

- Inquire into who initiated the transaction, who is recommending it, who is promoting it, and why a particular individual was approached as a potential investor. When there is an apparent effort to discourage questions from being asked, be suspicious of the reasons.

See also: Indicator 8 — Frustration of Due Diligence; Indicator 10 — Ensnarement and Psychological Inducements; Indicator 19 — Unsolicited E-Mail and Related Misuse of Technology; Addendum 1 — Performing Due Diligence.

Indicator 8: Frustration of Due Diligence

Since due diligence is the key tool through which suspicions can be explored and suspicious transactions avoided, it is a primary goal of fraudsters to frustrate the proper exercise of due diligence.

Explanation:

The person or entity being asked to make a decision with financial implications should ensure that due diligence is conducted through independent sources to investigate the proposed transaction, particularly any unusual aspects. The person being asked to invest should have the greatest motivation, and be best-placed, to conduct due diligence. Commercial frauds employ a wide variety of devices to frustrate the exercise of due diligence, whether by creating distractions; by creating false credibility through the impression of mass approval; by controlling the means by which due diligence is exercised; by directing the investor towards non-independent sources; through the use high-pressure sales tactics; through insistence on urgency or secrecy; or the like. Any attempt to thwart the complete and independent investigation of the transaction and especially unusual or questionable aspects is highly suspicious.

Instances and Examples:

- A fraudster may attempt to prevent the exercise of due diligence by:
 - Presenting information in support of the transaction that cannot be verified;

Illustration 8-1: A fraudster may suggest that eminent persons who cannot be contacted are involved with or have approved the transaction, or that the roots of the transaction lie in historical private or international agreements.

- Insisting on absolute secrecy;

Illustration 8-2: The fraudster promotes an investment to the potential victim but tells the potential victim that the investment and promised returns are only possible if absolute secrecy is maintained.

Illustration 8-3: The fraudster may claim that information used in promoting the investment is proprietary, secret, or confidential, and cannot be shared with independent sources for due diligence.

- Using high-pressure tactics;

Illustration 8-4: The fraudster insists that there is only a “short window of opportunity”, or a “last chance” to invest before the opportunity is lost forever.

Illustration 8-5: The sense of immediacy may be tied to unrelated but current world events or crises, such as political upheavals or natural disasters, in order to increase the pressure to invest quickly.

- Insisting that due diligence is unnecessary;

Illustration 8-6: In a situation where the fraudster controlled all parties to a transaction (the buyer, seller, and shipper), the buyer sought a letter of credit from its bank in favour of the seller. Although the goods did not even exist, the fraudster created forged documents that state that the goods had been delivered, and sought to draw on the letter of credit. To persuade the bank employee to issue the letter of credit, the fraudster persuaded the employee that he had spoken to the employee’s boss, who approved the transaction and the letter of credit, and the fraudster suggested that therefore the employee did not even require proof of ownership of the goods.

Illustration 8-7: A fraudster promotes a high-yield investment programme assisted by a lawyer and an accountant. Attendees at a seminar touting the investment programme hear presentations by the lawyer and accountant who claim to have examined the transaction and found it to be legitimate. Attendees are led to believe that the lawyer and accountant are independent, but they are each co-conspirators in the scam.

- Suggesting that the transaction has gained the approval either of the public or officials in the field;

Illustration 8-8: The fraudster promotes a high-yield investment programme to the potential victim and invites the potential victim to a seminar where the potential victim can learn more about the programme. The potential victim is taken to a seminar with hundreds of other potential investors. At the seminar, the fraudster touts his or her wealth, and may use the additional technique of promoting an association of the programme with well-known public figures, even if in a general way. All of these techniques generate a sense of mass approval intended to dissuade the victim from performing proper due diligence.

Illustration 8-9: Fraudsters can use any type of media, including print and electronic media, e-mail, television, live presentations, and the creation of convention-like events, to create a sense of mass approval of a certain “opportunity”, in order to distract the victim from performing due diligence.

- Suggesting that due diligence is being performed and therefore it is unnecessary for the investor to do separate due diligence;

Illustration 8-10: A fraudster can give the impression that due diligence is being exercised when it is not by claiming that it is being undertaken by a third party, or by insisting that a guarantee,

an escrow account, or some sort of outside professional involvement affords sufficient protection to the investor.

Illustration 8-11: A fraudster may recommend a specific professional to carry out the due diligence, but that professional has either been compromised by the fraudster, or has insufficient knowledge to carry out thorough due diligence.

- Or making due diligence impossible to accomplish, even while suggesting that the investor perform his or her own due diligence.

Illustration 8-12: A fraudster may encourage the potential investor to perform due diligence, but may effectively block its performance by providing incorrect or compromised contact information, creating excuses why key people cannot be contacted, providing insufficient detail regarding the transaction to perform the due diligence, and the like.

- Commercial fraud may be signalled where there is unusual difficulty in obtaining additional and independent information on the transaction or the parties, due to their identities, to their geographic location, or to other factors.

Illustration 8-13: Fraudulent transactions often involve international companies based off-shore, making due diligence more difficult.

- A fraudster may steer the potential victim toward non-independent sources of information when due diligence is being pursued, or may present false documents to bolster credibility.

Illustration 8-14: Fraudsters will use different means to frustrate due diligence, including setting up collaborators for the victim to call to verify information, and they have even been known to create elaborate shell businesses with actual premises when pursuing large investments from victims.

Advice:

- It is absolutely essential to seek independent advice from sources other than those provided by the person encouraging the investment.
- The person from whom advice is sought should be knowledgeable about the subject matter.
- The key facts of the transaction should be verified.
- Trust one's common sense and investigate thoroughly when an aspect causes one to feel uneasy.
- Be aware that modern commercial fraudsters often work in sophisticated groups that loosely corroborate and reinforce one another and the scheme.
- Evaluate the reasons for the immediacy, if any.
- Take time to investigate and do not rush into a business decision, especially when the decision is regarding something out of the ordinary course of one's business.

See also: All other indicators — effective due diligence is in all cases the key to avoid becoming a victim of fraud; Addendum 1 — Performing Due Diligence.

Indicator 9: Corrupted Incentives

Commercial frauds may involve taking advantage of an entity's performance incentives or offers of assistance, gifts, favours or other inducements to particular individuals in exchange for consideration that would not otherwise be available, or to overlook certain questionable activity.

Explanation:

Performance incentives designed in accordance with international and national laws, professional ethics and industry standards can be a useful tool for encouraging profitable performance, particularly when they are subject to rigorous oversight. However, they can also mask fundamental problems with an account or a relationship, or give employees strong incentives to ignore what might otherwise be troubling signs.

Unless properly communicated, reported upon and monitored, even the best-intended employee incentive programmes weaken an entity's protection from commercial fraud. In addition to the possibility of employees themselves engaging in fraudulent activity to obtain incentives from their employer, outsiders may corrupt otherwise legitimate employee incentive programmes by seeking out poorly-managed schemes and targeting employees prepared to exploit those weaknesses.

Another aspect of corrupt incentives in general is the use of gifts, status, favours, money, data, information or other inducements to create a conflict of interest for the recipient. By using such means to persuade senior management or other employees to engage in practices that are contrary to the generally accepted standards of prudent operation, fraudsters may use incentives to undermine the organization as a whole. What is sought can range from general amenability to help or to encourage the recipient to do something specific that is not improper in itself, but that facilitates something that is improper, to inducements that result in the recipient becoming a collaborator in the scheme.

Fraudsters may also mirror business incentives as a device in the course of their schemes: for example, by offering early investors financial incentives to recruit others in pyramid schemes, where payments are made from other participants' money. Fraudsters often use such incentives to persuade participants to "roll over" or reinvest illusory profits rather than be paid.

Instances and Examples:

- Employees or fraudsters will take advantage of poorly monitored corporate performance incentives, for example, to enter into continuing transactions even when such transactions seem suspicious.

Illustration 9-1: One hedge fund executive lost several hundred million dollars of investors' funds and deceived them and related institutions for more than three years using fake account statements.

- Gifts, status, favours, money, data, information, or other inducements that may create a conflict of interest for the recipient are intended to cause the

recipient to give consideration that would not otherwise be available or to overlook or examine things that would otherwise be suspicious or problematic.

Illustration 9-2: To curry favour, lenders provided all-expenses-paid trips for university financial aid officers and put university officials on their boards. Many universities operated as trusted middlemen by recommending these “preferred lenders” that did not necessarily offer the best rate to student borrowers.

- Internal and external incentives and gifts may signal corruption or fraud in certain identifiable ways.

Illustration 9-3: An employee is meeting very high performance expectations, with little oversight or understanding of transactions.

Illustration 9-4: Unusual hospitality or excessive professional fees or excessive consultants’ fees are offered.

Illustration 9-5: A businessman well-known for generosity gave very expensive gold watches to bankers and lawyers that made it difficult for them to ask difficult questions about the large loans that he took out and ultimately defaulted on.

- Commercial and financial decisions should be made on their own merits.

Illustration 9-6: The person whose influence is sought can be either the direct or indirect recipient of the gifts or favours, which may also be given to children, parents, spouses, etc.

Illustration 9-7: The fraudster’s goal is to obtain undue consideration or cooperation including obtaining contracts, information, documents, reducing the willingness to ask questions, providing access to people, compromising the integrity of the recipient or to encourage the recipient to become part of the scheme.

Illustration 9-8: Scheme incentives typically include promises of unusual or excessive returns and strong encouragement to re-invest the windfall.

Advice:

- The oversight of employee incentive programmes should include review and audit by independent persons.
- Systems should be in place to identify and resolve causes of employee grievances and to ensure that there are adequate and effective whistle-blowing policies.
- Employers should have policy guidelines in place regarding receipt and reporting of gifts and favours, and should ensure that employees are aware of, and adhere to, those guidelines.
- Professionals should be aware that they are often targets of attempts at improper inducements.

- When receiving a gift, any employee or professional should consider carefully the value of the gift and the identity of, and relationship with, the giver.
- Employers should ensure that purchases of gifts at company expense should be subject to review and approval by persons other than the donor.
- Investors must understand how returns on an investment are generated, ask questions when cautionary flags are raised, and be open to seeking confirmation from an expert advisor.

See also: Indicator 5 — Disproportionate Returns; Indicator 6 — Undue Secrecy; Indicator 8 — Frustration of Due Diligence; Indicator 13 — Questionable or Unknown Source of Repayment; Indicator 16 — Fraud By or Involving Employees; Indicator 20 — Pyramid and Multi-Level Marketing Schemes; Addendum 1 — Performing Due Diligence.

Indicator 10: Ensnarement and Psychological Inducements

Fraudsters may seek to entice victims by using psychological inducements and manipulation first to persuade them into participating in the fraud, and then to ensnare them with respect to the real or imagined illegality of their participation in the fraud. Such ensnarement is then used against them to distract them or to obtain their silence regarding the much more serious commercial fraud being committed.

Explanation:

Commercial frauds often use psychological inducements to encourage a financial decision-maker to enter into a fraudulent transaction, and then to avoid detection of the fraud. The most obvious inducement is an appeal to greed, but other factors can include flattery of the decision-maker, through gifts or references to investor sophistication or the general appeal of being included in a private and exclusive deal. Many fraudsters can be very charming and persuasive people.

In terms of ensnarement, there is a natural psychological and moral reluctance to commit an improper or illegal action. Where an investor is induced to commit an act that may be questionable or illegal by a person seeking to involve the investor in an investment or other financial opportunity, this may be a device to ensure their silence or to distract them from the commission of a commercial fraud. Later attempts to avoid detection can include such psychological tools as threats regarding disclosure and suggestions of collusion or ensnarement.

Instances and Examples:

- Fraudsters depend upon and prey upon powerful human emotions such as greed, pride, empathy or fear.

Illustration 10-1: Potential victims are seen by the fraudsters as predisposed to believe there are secret ways to make enormous amounts of money with no risk.

Illustration 10-2: While still in the enticement stages, a proponent of the investment appeals to the victim's ego by alluding to investment sophistication or by trying to make the victim feel foolish for asking for explanations of complex transactions or technical terms.

Illustration 10-3: In many common financial frauds, cheques and money orders are made out for amounts larger than the debt owed or commission to be paid to the victim, so that the victim is induced to deposit the cheque or money order in his or her bank account and to wire the balance of the funds to a foreign bank account before he or she is notified by the banks that the cheque or money order is counterfeit or invalid.

Illustration 10-4: Advance-fee fraud resorts to the victims' predisposition to cooperate with government regulations by inducing them to pay money to fraudsters for nonexistent "taxes", "fees", or "customs duties" before the fraudsters are expected to provide whatever goods or services (e.g., offshore tax shelters) they have promised to victims.

- Commercial fraud schemes may be designed to appeal to certain psychological profiles by suggesting 'secret' markets, conspiracies or exclusive business circles

Illustration 10-5: Those who may be seen as distrustful of government are offered investments to avoid paying taxes through offshore accounts. In one multi-million dollar fraud, victims were offered 80 percent annual returns through a secretive web of money dealers supposedly set up by a coalition of governments in 1914 to pay for World War I debt. The scheme claimed that seven "world traders" control the entire global money supply and act as a board of directors for a few hundred "licensed traders" around the world.

- Promoters look for weaknesses in population groups, concentrations of immigrants, the poor, the elderly and the infirm, preying on emotions such as the fears of senior citizens running out of money.

Illustration 10-6: In a common scheme, information is received by the elderly that the recipient has won a large "unclaimed prize" or international sweepstakes drawing or lottery that must be claimed by submitting an advance fee or by calling a telephone or mobile phone number to which significant charges apply.

Illustration 10-7: Victims may be more at risk depending on their particular profile or their stage in life, such as whether they are elderly, recently divorced, have health problems, or may have recently won or been awarded a substantial amount of cash.

- Some fraudsters use flattery and the veneer of sophistication to entice victims to participate in the fraudulent investment.

Illustration 10-8: The fraudsters may make a display of lavish lifestyles and expensive luxury goods as they offer sophisticated sounding but fictitious investment products that mimic the many new legitimate products, while counting on naïve investors not to ask questions to avoid seeming to be themselves unsophisticated.

- When other psychological inducements fail, fraudsters often resort to inducing compliance by threat or actual use of violence.

Illustration 10-9: Investors who have not realized they are victims are used to entice others to participate. When the fraud is discovered, these middlemen fear they, too, will be implicated, and the fraudster uses that fear to keep the middlemen quiet.

Illustration 10-10: Once a victim discovers the fraud, the fraudster may threaten public embarrassment by exposing involvement in the scheme, or may string the victim along with a series of mythical difficulties, or may offer the potential of new schemes with even greater returns, all common tactics used to delay or deter disclosure of activities.

Illustration 10-11: It may be suggested to an individual involved with the scheme, often a professional, that the professional has become a conduit for money-laundering, although perhaps unwittingly, and once implicated, the professional may be reluctant to report the scheme.

Illustration 10-12: A major telephone service provider was threatened because a fraudulently activated phone had been shut off. In a recorded telephone call, the fraudster threatened the telephone service provider that if the provider did not provide access to its computer system, he would cause its web service to collapse through a denial of service attack — an attack designed to ensure that a website is so flooded with requests for information that legitimate users cannot access the website.

Illustration 10-13: Fraudsters will try to frighten victims telling them that they are deeply implicated in the fraud and that they will not be allowed to escape the fraud, or that the fraudster has ways of seeing to it that they will be arrested by national or international law enforcement authorities. Witness intimidation is common in commercial fraud.

- Fraudsters rationalize that there are no real victims because their targets are avaricious, complicit and gullible.

Advice:

- Try to objectively appraise the merits of the proposed transaction, and be aware that suspicions that flow from one's own common sense appraisal should be taken seriously. Ask oneself "Why me? If this scheme really works, why is some stranger in a hotel meeting room or on the telephone or the Internet approaching me with a complicated financial deal with such high returns with an offer to allow me to participate?"
- One's ego should not override one's suspicions — keep asking questions, even though the scheme's promoter may intimate that one is foolish for not understanding. It is much more foolish to invest in something that is not completely understood.
- Obtain legal advice from independent counsel with the competence to advise regarding the transaction.
- Do not be discouraged from reporting a fraud to the authorities because of some ensnarement aspect.

See also: Indicator 4 — Misuse of Names; Indicator 6 — Undue Secrecy; Indicator 7 — Overly Complex or Overly Simplistic Transactions; Indicator 8 — Frustration of Due Diligence; Indicator 15 — Fraud Based on Abuse of Personal Affinity or Relationships; Indicator 17 — Unusual Involvement or Participation of Professionals; Addendum 1 — Performing Due Diligence.

Indicator 11: Crisis-Caused Breakdowns in Preventive Controls

Commercial frauds may exploit weaknesses in control systems in order to take advantage of generous or emotional impulses in the aftermath of natural and man-made disasters.

Explanation:

A hallmark of civilization is the exercise of generous impulses and actions towards those less fortunate. Natural and man-made disasters bring forth such impulses spontaneously. In response to recent hurricanes, typhoons, earthquakes and tsunamis, the public and private sectors of the international community have worked together and spent billions on recovery. The mass destruction of homes, businesses and public infrastructure and the displacement of millions of individuals require emergency action, characterized by trust in common purpose. Commercial entities and transactions have a significant role in making possible support of disaster recovery by the private and public sectors. However, coincident with the common good, neither the presence of an emergency nor our natural crisis-driven impulse of mutual trust should take the place of understanding the investment or business transaction, or of the exercise of due diligence and vigilance in preventive controls. A key lesson of past disasters is that funding lost to fraud slowed the recovery effort and reduced the amount of support that could have been delivered to alleviate the suffering and needs of legitimate victims.

Fraudulent schemes anticipate that, in the aftermath of disasters, individuals, businesses and governments will tend to suspend due diligence or circumvent the operation of normal preventive controls. In the mental model of fraudsters, disasters create opportunities by opening or exposing control weaknesses at a time of enhanced national or international urgency and when there is a general heightened emotion on the part of populations wishing to place trust in a common purpose.

Instances and Examples:

- The outpouring of public generosity in the immediate aftermath of a disaster is often manipulated by attempts to exploit charities or charitable giving.

Illustration 11-1: There are always some fraud schemes involving solicitations for ostensibly charitable purposes. When natural disasters strike, the incidence of such schemes can rise dramatically. After the terrorist attacks of September 11, 2001, the Indian Ocean Tsunami and Hurricanes Katrina and Rita, for example, law enforcement authorities saw a significant number of schemes that purported to be collecting money for first responders and survivors of the disasters.

Illustration 11-2: “High-yield” investment schemes spring up very quickly after major disasters or world events. Characteristic of such schemes the selling tactics are not aimed at a purely charitable purpose but mix the promise of great profits with alleged charitable or “humanitarian project” benefits. Often fraudsters allege that the scheme is “sanctioned by the United Nations” or that it is a “UN approved programme for investment”.

- As governments organize for response, fraudsters search for control weaknesses in their procurement, benefit and grant processing.

Illustration 11-3: Procurement fraud schemes, such as kickbacks from vendors to contracting agency employees in exchange for favourable treatment, occur with frequency in contracts for procurement of goods and services after large-scale natural disasters, when many governments and international agencies enter into contracts for debris removal and infrastructure rebuilding.

Illustration 11-4: Fraudsters pressure evacuees to give the fraudsters permission to receive their mail. Government disaster assistance cheques intended for the evacuees are sent to the fraudsters’ addresses and then diverted to secure cash or buy goods from local businesses. Often the goods are then sold directly or through online auctions initiated by fraudsters in other regions, or even other nations, serving as “brokers” for theft rings in the immediate area of the disaster.

- As private sector resources are accessed to engage in disaster recovery, fraudsters take advantage of information gaps in the damage assessment process and systemic breakdowns in controls normally associated with financial systems.

Illustration 11-5: Examples of insurance fraud include fraudulent claims for property damage or loss, or for feigned physical injury, and false claims for renovations due to disaster damage, as well as sales of false insurance contracts.

Illustration 11-6: Displaced financial institutions attempting to provide emergency banking services to disaster survivors experience an increase in cheque kiting: the use of several bank accounts in different geographic areas to make deposits and write cheques against the accounts before the deposit cheques clear the banking system, creating a “float” of money out of nothing more than the lag in time while cheques clear and post to their respective accounts.

Advice:

- Exercise any charitable impulses through appropriate and recognized charities.
- Where there are claims that an investment will not only achieve high returns, but that it has the additional benefit of humanitarian purposes, disaster relief, or the like; or where such motives are held out as a basis for justifying investments or other financial opportunities that are not

explicable or justifiable on their own business terms, there may be an indication of commercial fraud.

- The sudden interjection of a commercial transaction in a non-commercial setting should raise concern that there is no real or logical connection between the charitable cause and the proposed scheme.
- With a focus on substantially diminishing the opportunity for fraudulent access to systems through front-end controls, preventive controls are a key element of an effective fraud-prevention programme.
- Well before any disaster, preventive controls should be field tested to ensure they operate as intended.
- Repeat offenders are common in Internet-based fraud. Databases of prior fraud, as a defensive method, for example to compare elements of incoming orders to information in the prior-fraud database, may guard against repeat false orders or invoices.
- A well-trained work force that is aware of the potential for fraud can help prevent fraud. Fraud awareness training with frontline personnel — specifically on the potential for fraud within the programme and the likely types of fraud they could encounter — is crucial to stopping fraud before it gains access into the business or government operation.

See also: Indicator 8 — Frustration of Due Diligence; Indicator 15 — Fraud Based on Abuse of Personal Affinity or Relationships; Addendum 1 — Performing Due Diligence.

Indicator 12: Immediate, Fast or Irrevocable Transfer of Funds

Commercial frauds often pressure potential investors not only to make a very rapid decision, but also to immediately or quickly transfer funds, leaving little to no time for due diligence or reliance on expert advice.

Explanation:

Legitimate transactions often require quick decisions and immediate action. However, the individuals or entities engaged in such transactions typically are able to participate because of a prior understanding of the nature of the risks and rewards involved. Thus, those individuals and entities do not suspend due diligence in favour of quick decision-making, but instead, exercise due diligence of a different variety, or at different points in the transaction.

A fraudster will often persuade a victim of the need for quick decisions in an attempt to thwart due diligence or to effect an irrevocable transfer of funds in the fraudster's favour. A person or entity being asked to make a decision with financial implications may be pressured to effect immediate, fast or irrevocable transfers of funds in order to complete the transaction. Once sums have been transferred, they are easily further transferred by the fraudster, often into other international jurisdictions that may make retrieval or tracing difficult or impossible.

Instances and Examples:

- The fraudster will insist on an immediate transfer of funds, leaving little or no time for even basic due diligence.

Illustration 12-1: The promoter of an investment touts the investment's certain rewards and high yield. At the same time, the promoter will warn the potential victim that the investment opportunity "will not last", or is a "once in a lifetime opportunity", and that the victim must "act fast". The promoter insists on a quick decision before the victim has sufficient time to thoroughly review the transaction.

- The immediacy of the transaction may be used to induce the victim to agree to additional terms.

Illustration 12-2: An investor is induced to authorize a transfer to a new account established for the fraud. Because of an alleged need for urgency and convenience, the investor is induced to add the fraudster or his or her accomplice as a co-signer on the new account. The fraudster and co-signer then transfer the funds in the new account into their control.

- A fraud may also involve the immediate and irrevocable transfer of funds to off-shore companies.

Illustration 12-3: A transaction involves transfers to an off-shore company described as an "anonymous" off-shore company, or to an off-shore company, trust, or account in a "tax-haven" jurisdiction.

Advice:

- Do not be induced to enter into a transaction before exercising the requisite due diligence because of pressure and time limitations.
- Never relinquish control over banking or investment accounts.
- Understand the reasons given for any transfer of funds, especially when a transaction involves multiple transfers.
- Be particularly vigilant regarding transfers of money to another jurisdiction, especially off-shore jurisdictions which have secrecy laws and make any recovery of transferred funds extremely difficult and cost-prohibitive.

See also: Indicator 6 — Undue Secrecy; Indicator 8 — Frustration of Due Diligence; Addendum 1 — Performing Due Diligence.

Indicator 13: Questionable or Unknown Source of Repayment

Commercial frauds often obscure the source of payment of alleged earnings or returns on an investment by referring to vague sources, foreign sources, uncertain sources, such as generic "trading programmes" (sometimes on "secret" markets), or by suggesting sources of payment in unregulated international jurisdictions or from non-regulated entities.

Explanation:

Knowing the source of repayment, as well as compliance with documented procedures that ensure accurate, timely repayment of earnings and returns is essential to legitimate commercial transactions. In commercial transactions, genuine

financial intermediaries possess sound principles of management, clear business models and documented and well-executed processes that are subjected to ongoing evaluation of efficiencies. Efficient repayment operations are conditioned on clear and known rules and accurate communications with trusted counterparties. Commercial transactions often require foreign sources of repayment, however, transactions typically do not include unexplained complexities, or use of inefficient repayment methods, or requirements that sources of repayment depend upon unregulated international jurisdictions. Nor would it be usual for an offshore or foreign source of repayment to be part of an otherwise wholly domestic transaction. The person or entity being asked to make a decision with financial implications must understand the business reasons justifying the underlying transaction, and determine the specific commercial reasons for any complexities, and must know, with certainty, the source of repayment.

Fraudulent schemes often entice prospective investors into not questioning the source or method of repayment by offering unusual financial incentives that are not related to the underlying transaction, or that have no commercial justification. Investors may be lured by an “enhanced rate of return” to accept a promise of repayment from an entity with no discernable business connection to the transaction. Often, part of a fraudulent scheme may depend on the investor agreeing to repayments transacted through jurisdictions regarded as secrecy havens. This “offshore source” feature subjects the victim to further manipulation: by agreeing to unusual sources of repayment in exchange for the potential to avoid paying any taxes on proposed returns, the investor becomes complicit in the scheme. Vague, uncertain or offshore sources of repayment are often used to keep investors in a state of doubt, so that a fraud is not noticed until it is too late.

Instances and Examples:

- The true nature of a transaction will be obscured, will likely lack commercial purpose, and will have improbable characteristics, such as disproportionate returns.

Illustration 13-1: “Historical bonds”, or bonds that were once valid obligations of commercial or sovereign entities but that are now worthless as securities and only collected or traded as memorabilia, are said to be worth millions or billions of dollars based on third-party statements often referred to as “hypothecated authentications” or “hypothetical valuations”, and are sold to unsophisticated investors at inflated prices far exceeding their value as collectibles.

- Returns are claimed to be from purported sales of more of a commodity than is produced or available in the world.

Illustration 13-2: The source of repayment is claimed to be gold, that is “collateralized” by fictitious “gold certificates” or “warehouse receipts”, variously said to have been issued by obscure or non-existent offshore banks, or by major financial institutions, or even by well-known international organizations, representing gold bullion that, if true, would require more gold than produced in recorded history.

- Repayments are sourced from other participants’ investments or from a participant’s own investment.

Illustration 13-3: In one “pyramid scheme” a “trading company” sold bags of ants asking investors to breed the insects and bring them back for a 130 per cent return. Initially, the purchase money received from new investors was used to pay returns to the previous investors. Pyramid schemes reach critical mass, and collapse, when the source of funds from new investors is inadequate for repayment of prior investors.

Illustration 13-4: After falling for “high-yield”, “Prime Bank” investment fraud, victims are often approached by a second team of fraudsters with an offer of “fraud recovery” services. Small amounts are “recovered” in exchange for an “advance fee”. The victims are then pressured for additional and more substantial fees, and promised “more complex” higher value recoveries. The source of all funds “recovered” by the second team is the victims’ own funds in the hands of the first team. The fraud continues until the second team has extracted all the fees the victims are willing or able to pay. By this time, the victims will have lost all funds initially “invested” with the first team and all “advance fees” paid to the second team.

Advice:

- Be able to identify the commercial purpose of the transaction and understand how the returns are generated.
- An overemphasis on esoteric details, such as “historical bonds”, overly complex methods of payment, inconsistent explanations regarding sources of repayment, and unusual requirements predicate to earnings, are not typical of legitimate business dealings.
- When returns are overdue an investor should immediately seek independent, objective advice and accept no excuse.
- When a major source of returns is derived from inducing others to invest and, in turn, recruit others, great care must be exercised regarding the legitimacy of the scheme. If the major commercial purpose is obtaining percentages of investments from lower tier investors, it could be a so-called “pyramid scheme”.
- Do not become so focused on the amount of the alleged returns on the investment that one forgets to focus on the source of those returns.
- Be suspicious of repayment methods or sources that involve entities, jurisdictions or complexities having no discernable business justification in connection with the transaction.
- References to “high yield” and “no risk” investments in “secret trading programmes” or “secret trading rooms” in “tax-free” or “bank privacy” jurisdictions signal that the transaction departs from commercial norms and that there may be no commercial source of repayment. If confronted with such terms, investors must aggressively conduct due diligence.

See also: Indicator 5 — Disproportionate Returns; Indicator 8 — Frustration of Due Diligence; Indicator 9 — Corrupted Incentives; Indicator 10 — Ensnarement and Psychological Inducements; Indicator 20

— Pyramid and Multi-Level Marketing Schemes; Addendum 1 —
Performing Due Diligence.

Indicator 14: Irrational or Illogical Aspects or Explanations

Once an investment has been made, in an effort to prolong the fraud or to hide the proceeds, a fraudster often relies upon any available or superficially plausible reason to explain any aspect that is questioned. Often, these excuses or explanations will not bear close scrutiny and will reveal the commercial fraud.

Explanation:

Modern commerce and finance has a rational and systematic character. Although it may sometimes be difficult to understand, there are always commercial, historical, systemic, or other reasons for its features that can be understood and explained. Where there are irrational or illogical elements of an instrument or scheme, particularly with respect to failed performances, further investigation is warranted and an independent expert should be consulted.

A fraudster will frequently give inconsistent or illogical explanations to persuade the potential victim not to seek such advice, to prolong the fraud, or to hide the proceeds of the fraud. The victim may be given illogical explanations that attempt to induce the victim to participate further in the fraud. Or, when the proceeds are delayed, the fraudster may claim that returns due the investor are delayed by natural disasters, current events, or other such events that typically would not affect transactions of the type contemplated. The victim may also be induced to remain silent about the transaction based upon threats that reporting will delay payment or make payment impossible.

Instances and Examples:

- Fraudulent transactions may involve illogical explanations as to counterparties' roles or identities in the transaction.

Illustration 14-1: The fraud may involve unlikely connections in the overall scheme, such as a banking transaction with organizations that are not banks, such as the United Nations or the International Chamber of Commerce, or a private banking transaction with an international banking institution that does not conduct retail banking, such as the International Monetary Fund or the World Bank.

Illustration 14-2: The fraudster may describe clients or counterparties whom the victim never meets. For example, a lawyer promotes a transaction in which a "client" will trade financial instruments as a member of a secret inter-bank market in these instruments, but the client is never identified or introduced to the victim.

- Irrational or illogical aspects may appear in the very fundamentals of the transaction.

Illustration 14-3: There may be a serious disproportion in the overall structure of the transaction, such as a relatively small transaction with a huge, powerful bank allegedly behind it.

Illustration 14-4: Illogical logistics may appear, for example, in the sale of goods, where the movements of such goods do not make sense geographically in terms of where they are typically produced or grown.

- Irrational or illogical explanations may also be used to explain delays in realizing the proceeds of a transaction. In most situations, the reason claimed for the delay bears little relationship to any actual or likely delay in the transaction.

Illustration 14-5: The fraudster may involve claims of delays falsely attributed to legal considerations, governmental interference, current events such as natural disasters or political changes. In one case, for example, the fraudster claimed that international payment systems were shut down after the death of a member of the Royal Family, and the proceeds of a transaction would not be available until after the systems had been reopened.

- A fraudster may actively discourage reporting the current failure to complete a transaction or the failure to make payment by claiming that doing so will make future completion or payment impossible.

Illustration 14-6: When proceeds are not realized, the fraudster may tell victims that realization of the investment is pending and that, if reported, the authorities will not understand the transaction and will cause unnecessary delays while they investigate it.

Illustration 14-7: When a victim questions the fraudster about delayed proceeds, the fraudster may attempt to ensure silence by leading the victim to believe that he or she, too, is implicated in any fraudulent conduct. For example, the fraudster may admit to the victim that the transaction is of questionable legality but that because the victim had received some proceeds from other victims, he or she is just as guilty as the fraudster.

Advice:

- Think critically about the logic or likelihood of explanations, and when the explanations are not understood, do not be embarrassed or afraid to seek independent advice.
- Always ask the promoter of a transaction to explain necessary terms or critical roles if they are not understood. Be suspicious of a promoter who cannot explain vital roles or terms satisfactorily, and be willing to seek objective advice in such cases.
- It is better to face unpleasant suspicions and investigate them sooner rather than later, since time is always in favour of the fraudster.
- If there is doubt, seek assistance from the authorities.

See also: Indicator 3 — Inconsistencies in the Transaction; Indicator 8 — Frustration of Due Diligence; Addendum 1 — Performing Due Diligence.

Indicator 15: Fraud Based on Abuse of Personal Affinity or Relationships

Commercial frauds often take advantage of non-economic factors like the natural trust between people of similar backgrounds to cause potential victims to reduce the due diligence that they would otherwise exercise and to use the group as a source of potential victims. Moreover, commercial frauds often tailor themselves to the beliefs or commonalities that unite or are characteristic of a group.

Explanation:

It is normal to give credibility to and to defer to those with whom one is closely associated such as relatives, friends, or those of similar backgrounds, including religious, social, political, ethnic, charitable, fraternal and other relationships. Commercial frauds often play on these affinities to promote themselves and cause investors to substitute the security of the affinity for understanding or seeking out advice with respect to the proposed investment. The problem lies not in the affinity or relationship, but in an excessive reliance on the common linkage instead of objective factors related to the proposed investment.

Instances and Examples:

- Relationships that can be abused include:

- Family relationships;

Illustration 15-1: Fraudsters often induce relatives and friends to invest in a scheme of which they would otherwise have been sceptical.

- Sports teams or apparent celebrity endorsements;

Illustration 15-2: The fraudster uses the reputation of a major sports figure to induce and promote investments that are fraudulent.

Illustration 15-3: An eminent citizen or celebrity is invited to an event promoting an investment, and by accepting the invitation, appears to be personally endorsing the investment.

- Religious or cultural affinity;

Illustration 15-4: A religious or cultural group is encouraged by other members or a leader to join an investment scheme that purports to benefit their common faith or heritage only on the basis of that relationship.

Illustration 15-5: A group suddenly becomes focused on a particular investment or scheme, seeming to support it en masse, when it is unrelated to the purpose or common theme of the group.

Illustration 15-6: A previously unknown individual becomes a member of a particular group, becomes influential in the group, and strongly encourages a particular investment or scheme to members of that group.

Illustration 15-7: A sudden change in the group dynamic from a religious or cultural focus to a more commercially-oriented one.

- Or charities.

Illustration 15-8: A fraudster uses a current tragedy to set up a false charity whose proceeds benefit the fraudster and affiliates and not the victims of the tragedy.

Illustration 15-9: It is common for commercial frauds to state that a certain portion of funds will be used to benefit a given humanitarian or other charitable cause.

- Assurances: The fraudster may attempt to link the fraud to the group to provide added comfort.

Illustration 15-10: Fraudster may convince a group that funds invested will remain in the control of the group.

- The credibility of these schemes can be enhanced considerably by returns paid as promised from the same money invested or the investments of others.

Advice:

- Trust based on shared interests or relationships should not take the place of understanding the investment or business transaction or of the exercise of due diligence and vigilance in protecting one's interests.
- Think independently.
- Do not substitute the friendly advice or suggestions of an acquaintance from a social or other group for professional advice when finances are involved.
- Because a counterparty has had a history of financial solvency in the past, do not assume that it is necessarily solvent today.
- Knowing one's counterparty must be an ongoing process, since circumstances can change, and business stresses can lead to reckless and fraudulent behaviour even in a previously legitimate business.
- Do not allow outward trappings like expensive cocktail parties at luxurious hotels, or meetings of like-minded individuals, to cloud one's judgment regarding a potential investment.
- Be careful which invitations are accepted and thus those to which one's name and reputation are lent.

See also: Indicator 4 — Misuse of Names; Indicator 5 — Disproportionate Returns; Indicator 8 — Due Diligence; Indicator 10 — Ensnarement and Psychological Inducements; Indicator 11 — Misuse of Motives; Indicator 20 — Pyramid and Multi-Level Marketing Schemes; Addendum 1 — Performing Due Diligence.

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Indicator 16: Fraud By or Involving Employees

Employees (or other corporate insiders with access to similar information or systems, including agents, contractors, and affiliated companies and parties) of all levels can be involved in a variety of frauds ranging from obtaining a position of trust with a view toward perpetrating a fraud, to taking advantage of an opportunity or situation within an entity either alone or in concert with other employees or outsiders.

Explanation:

All businesses operate through employees. Employees, however, have access to non-public information (including information that is confidential or proprietary) and are effectively placed in positions of trust. Commercial frauds are often accomplished with the involvement of employees of the entity that is being defrauded. Frauds may involve managers, employees with professional designations, outside consultants, highly overqualified employees in sensitive positions, poorly-vetted temporary employees, and senior or highly-experienced employees who are perceived to be unchallengeable. Various frauds are possible, and may include the movement of funds, the acquisition and sale or inappropriate use of sensitive information, inventory fraud, procurement fraud, and accounting frauds to inflate assets or earnings. Motivations or opportunities for employee fraud may include overambitious performance targets, annual bonus or incentive programmes, grievances, or lack of sufficient supervision or internal controls.

Instances and Examples:

- Fraudsters may seek to place themselves or an overqualified employee in an easily-obtained but lower-level position in order to illicitly obtain information or other valuable data for various improper purposes.

Illustration 16-1: Cleaning or maintenance staff having unsupervised access to sensitive information sells the information.

Illustration 16-2: Temporary staff with decision-making power has access to valuable documents, steals and sells them.

- An employee who does not have sufficient skills to perform when he or she is under-qualified for a position may feel pressure to commit fraud to achieve mandated performance goals or to appear to comply with performance expectations. Extravagant bonuses tied to unrealistic performance goals may motivate employees to participate in fraudulent schemes to achieve bonuses.
- An unhappy employee or one who does not believe he or she is properly appreciated may engage in fraud or be a target for a fraudster to use in a fraud against the company.

Illustration 16-3: A disgruntled employee seeks to punish a company by participating in a fraud.

Illustration 16-4: A disgruntled employee may accept kickbacks or bribes to make up for perceived lack of appreciation.

Illustration 16-5: An employee who feels unappreciated becomes involved in bid-rigging or price-fixing.

- Employees may be tempted to use their ability to access business assets, including non-balance sheet assets such as customer lists, for their own purposes.

Illustration 16-6: An employee may be making unauthorized personal use of business assets to enrich themselves — even low level fraud like unauthorized telephone charges or access to office supplies can add up over time.

Illustration 16-7: An employee may engage in expense account manipulation.

Illustration 16-8: An employee without an understanding of the importance of data may be approached to sell seemingly insignificant information.

- Employees may be requested or pressured by senior managers to assist in a fraud conducted at the company itself, or on behalf of the company for which they work.

Illustration 16-9: A senior banker facilitated a multi-million dollar cheque fraud operation for the benefit of a personal friend, overriding the bank's internal controls by directing a junior employee to approve transactions while the senior banker was on holiday. In fear of losing his job if he refused, the junior employee acquiesced, and detection of the fraud was avoided.

- The work of a senior employee may be perceived as too complex, too important or too lucrative for it to be challenged or examined, and any fraudulent activity thus remains undetected.

Illustration 16-10: A multi-partner firm of lawyers was ruined by the activities of a dominant and apparently successful senior partner who was facilitating massive frauds.

Illustration 16-11: A very large firm of lawyers suffered reputational and financial damage in the millions arising from work by a partner which others often remarked upon as being odd but clearly too complex for them to understand.

Advice:

- Entities should use independent auditing committees, analytical review and surprise audits of both successful and unsuccessful aspects of operations.
- Employers should create fraud and conflict of interest policies and should ensure that employees are informed of them and trained in their operation.
- Employers should have effective whistleblower policies in place, and ensure that employees are informed of them and have confidence in their operation.
- Employers should ensure that all employees and senior managers are adequately supervised.
- Employers should perform periodic reviews of company contracts and agreements to eliminate contract and procurement fraud, such as kickbacks, bribery and conflicts of interest.
- Employers should ensure that no single employee possesses too many decision-making powers, and that there is an appropriate separation of important responsibilities amongst employees within an entity, as well as effective internal oversight.
- Employers should impose mandatory vacations: employee fraud is often detected when the wrongdoer is not present to control the situation, and employee fraudsters often never take holidays or may work unusual hours in comparison with other employees in the company.
- Employers should create periodic job rotation, provided it is consistent with local labour laws.
- Employers should have employee assistance programmes to help employees deal with the pressures of dealing with issues such as addiction, family problems, or economic hardship.
- Employers should consider programmes to encourage loyalty amongst employees, including paying them competitive salaries.
- Employers should be alert for sudden changes in an employees' lifestyle, including extravagant purchases or excessive lines of credit.
- Employers should ensure that the knowledge and skill of employees are consistent with the position they hold.

- Employers should check references or credentials in employment applications or resumes.
- In general, employers must create a robust control environment in the business in order to prevent fraud.

See also: Indicator 8 — Frustration of Due Diligence; Indicator 9 — Corrupted Incentives; Addendum 1 — Performing Due Diligence.

Indicator 17: Unusual Involvement or Participation of Professionals

The involvement of a professional does not guarantee that a transaction is necessarily genuine, particularly when the involvement seems unusual in some way.

Explanation:

Commercial transactions naturally involve professionals in a variety of roles. Moreover, businesses rely on professionals for advice and to protect them from commercial fraud. They may use an attorney to draft the documents used in a transaction; an accountant to give advice regarding how a transaction should be recorded on the company's books or on its tax implications; or a financial adviser or a banker to recommend a particular transaction or to give advice regarding certain types of transactions.

However, where the professional's involvement in the transaction seems unusual, a commercial fraud may be indicated. Where the professional provides no advice or services, but simply transfers money, or where the professional performs acts typically performed by another type of professional, a fraud may be present. Fraud may also be indicated where heavy reliance is placed upon a particular professional who is provided by the promoter of the investment to the exclusion of independent advice or due diligence from an outside professional. In addition, an individual acting as a professional should have the proper education and experience to provide the advice or services expected.

Instances and Examples:

- An individual who lacks proper credentials, or whose credentials cannot easily be verified, performs acts typically, or exclusively, performed by professionals.

Illustration 17-1: A fraudster promoting an investment scheme provides potential investors with the testimony of an individual who verifies that the transactions in a particular instrument are legitimate. The individual is not presented as an attorney, accountant, or financial adviser and holds no such credentials.

Illustration 17-2: The professionals involved have a disciplinary history, possibly including customer complaints, civil actions, or criminal prosecutions.

- The promoter of a transaction relies heavily upon, and advocates resort to, a particular professional working with the promoter, to the exclusion of independent advice.

Illustration 17-3: A promoter assures potential investors that a transaction has been approved by an attorney named and advocated

by the promoter, and encourages the investors to direct all questions to that attorney. The promoter may also state that other attorneys will deny the existence of the transaction, because they are not experienced enough to be aware of such transactions.

- A professional may provide no advice in connection with a transaction but will simply hold or transfer money, and if the professional is an unwitting participant in the scheme, may receive handsome fees simply for holding or transferring money.

Illustration 17-4: A party is informed that an accountant or lawyer will participate in a transaction, but the accountant or lawyer's only role is to accept money from that party and transfer the funds to the fraudster. Fraudster uses this arrangement to hide the sources of funds, and possibly to influence the professional by alleging his or her involvement in money-laundering.

- A fraudster may use reputable advisers, but restrict their terms of reference or provide them with false or misleading information.

Illustration 17-5: An independent lawyer or an accountant is engaged to assist on the transaction, but is provided with false financial statements and accounting records.

Advice:

- If in doubt about a professional, seek independent advice, such as one's own professional advisor who is known and trusted; never rely solely on advice given by professionals suggested by one's counterparty.
- Never suspend due diligence solely because a counterparty's professional advisor claims to have found the transaction to be legitimate.
- If a professional recommended by the promoter of the investment is involved in the transaction, check that professional's credentials and disciplinary history with any available licensing or regulatory authorities.
- Professional indemnity insurance and fidelity funds often refuse to cover losses arising from frauds. Do not rely on such cover as a substitute for due diligence.
- Professionals should question unusual instructions received from their clients.
- Professionals who are sole practitioners or part of a small firm and are involved in apparently very high value transactions and receiving high fees for little or no services should question the purpose of their professional involvement.
- Professionals should be careful of being drawn into transactions that they do not understand or are unsure about, particularly if they are offered unusual inducements such as a very high level of fees or overly generous hospitality.

See also: Indicator 1 — Irregular Documents; Indicator 4 — Misuse of Names; Indicator 8 — Frustration of Due Diligence; Indicator 10 —

Ensnarement and Psychological Inducements; Addendum 1 — Performing Due Diligence.

Indicator 18: Inappropriate Requests for Information Disclosure

Commercial frauds often rely on information obtained using means or a manner that would be unusual or inappropriate in certain circumstances; such information may be used to perpetrate a fraud against the individual or entity from whom the information is requested or against others.

Explanation:

The perpetration of commercial fraud requires that the fraudster gather information both to prepare the architecture of the fraud and in order to identify potential victims. To this end, customer lists of an entity may be sought in order to identify possible victims, or internal directories of the entity may be sought, which the fraudster may use to provide himself an identity, to lend the fraud credibility, or to identify possible accomplices. The fraudster may also need documents, logos, or trademarks produced by an entity to copy in order to steal the entity's identity. Further, the fraudster may seek to obtain vital personal identification in order to steal an individual's identity. Such information may be sought in person, or by means of e-mail, telephone, or fax solicitations.

The circumstances under which such information is requested may be inappropriate or unusual so as to signal a possible fraud. The request may be inappropriate, because the information requested is not usually disclosed using the form of communication requested, or, in more extreme examples, the request may be for sensitive information that is never disclosed in the manner requested by the fraudster. The request may seem unusual, because it concerns information not typically disclosed to an individual in the fraudster's position, or the request may be a part of a pattern of unusual requests of the entity or individual. Further, the request may be inappropriate, because the person asked to provide such information is not in a position to make such disclosures. Theft of information and identity fraud is a growing problem, for both individuals and organizations, and persons involved in commerce or finance should value information and should carefully consider any information disclosures that are requested.

Instances and Examples:

- A fraudster may request information to be supplied in a manner not typically used to supply such information, or technology may be used to inappropriately access confidential information.

Illustration 18-1: In a "phishing" scheme, a fraudster copies an entity's website or trademarks and sends an unsolicited e-mail to potential victims using the copied material to trick the victim into believing the entity has sent the e-mail. The fraudster asks the potential victims to fill in sensitive personal information, such as bank account numbers or personal identification details and reply. The fraudster then uses the information to steal from the victims' accounts.

Illustration 18-2: Information stored or conveyed using technology may be subject to inadvertent disclosure, since personal organizers

and mobile phones can be connected to computers to access information, and wireless technology is highly vulnerable given easily obtainable scanning equipment. “Keystroking” devices or software (or spyware) may be used to record and sift every keystroke made on personal computers.

Illustration 18-3: Aggressive telephone solicitations may purport to be promoting disaster-related relief, technologies or products (external or internal) in an effort to gain sensitive personal information.

- The request may be for information that the entity or individual does not typically supply to individuals in the fraudster’s position.

Illustration 18-4: Commercial frauds often involve requests for seemingly innocuous information, which an entity typically would not provide to customers or other individuals outside the entity. For example, the fraudster may request customer lists, internal telephone directories, and the like, which the fraudster may use to contact potential victims or to impersonate the entity’s employees.

Illustration 18-5: An entity is requested to provide an explanation of an entity’s product or service on that entity’s letterhead. The fraudster then uses the entity’s letterhead to impersonate the entity or lend credibility to his or her scheme.

Illustration 18-6: An attorney is asked to verify that a client or business associate is familiar to the attorney or that the client or business associate is trustworthy. The client or business associate, a fraudster, then shows the letter to potential victims so that they are induced to invest with the fraudster.

- A request may also be unusual, because the individual asked to disclose information is not in a position to make such disclosures.

Illustration 18-7: Fraudster requests that a bank teller issue a letter indicating that the fraudster has deposited with the bank “good, clean funds of a non-criminal origin”. The teller, believing the requested statement to be true, issues what is believed to be a harmless letter, which the fraudster then uses in an investment scam to give credibility to himself and to the fraud.

- A fraud may be indicated where unusual patterns of access have been made to a corporate database.

Illustration 18-8: A corporate database is accessed multiple times by individuals outside the company. A fraudster may access such information to create lists of potential victims or to steal the identities of the listed individuals.

Advice:

- Business entities should protect confidential information through the implementation of instructions relating to access to and use of confidential information and through careful training of employees who have regular

contact with the public, as well as by limiting which employees have access to such information.

- Where appropriate to protect confidential information, employees should be requested to sign confidentiality agreements to protect highly sensitive information.
- Any unusual requests for information should be carefully considered before an entity or individual complies.
- Only use secure means when conveying sensitive information, such as credit card or bank account numbers, and destroy or protect receipts or other documents bearing such sensitive information.
- Entities should employ both effective monitoring processes and effective security processes to ensure that confidential information cannot be accessed by those outside the company and that the entity is aware of attempts at access.
- Entities should ensure that effective computer data protection policies and procedures are in place to guard against hacking and computer misuse, that confidential information is secure, and that any attempt to override the policies is a disciplinary offence.

See also: Indicator 8 — Frustration of Due Diligence; Indicator 19 — Unsolicited E-mail and Related Misuse of Technology; Addendum 1 — Performing Due Diligence.

Indicator 19: Unsolicited E-mail and Related Misuse of Technology

The significant increase in the commercial use of information and communication technologies worldwide has introduced a corresponding increase in frauds which target commerce and which take advantage of technologies to reduce risks and increase potential proceeds and the number of victims.

Explanation:

Wire line telephones, wireless or cellular telephones, fax machines, electronic mail and the Internet are examples of technologies that are available in both urban and rural areas throughout the world, and which are heavily used in commercial activities. There is a relationship between the availability and use of information, communication and commercial technologies and commercial transnational fraud. As one example, many companies seek to expand domestic and international markets by advertising their products or services for sale via the Internet, thereby attracting online attacks against the company, its systems and its customers.

Information, communication and commercial technologies are used as tools to defraud victims and to transfer and conceal proceeds. Fraud imitates legitimate commerce, making variations of commercial practice likely to produce corresponding variations in commercial fraud over time, between countries or regions, and with respect to specific areas of commerce. The number of fraud victims, total proceeds of fraud, occurrences of transnational fraud, and fraud involving technologies have seen an increase, corresponding to the increased use of technologies in commercial systems and the availability of technologies to offenders and victims.

Instances and Examples:

- Technologies are used to update and to increase the effectiveness of paper-based frauds that may date back hundreds of years.

Illustration 19-1: One type of advance fee “phishing” fraud known as “419” uses the Internet and electronic mail to develop contacts and to pursue victims. A “419” fraud is a computer version of an ancient “your friend is a captive” fraud, in which hundreds of letters would be sent to wealthy families offering to free an imaginary victim in exchange for an advance fee. Using computers, in “419” frauds a few individuals are able to send billions of unsolicited e-mails worldwide promising the release of captive fortunes, a share of which may be obtained in exchange for personal or financial information of the victims and the payment of an advance fee. The wealth of the victims is siphoned off and their identity and financial information is used to carry out additional frauds.

- A general sense of confidence in global commercial and payment systems is used to lull suppliers into inaction and to suspend normal credit and payment controls.

Illustration 19-2: A supplier of diesel generators receives a large Internet order from an overseas buyer. Excited by the amount of the sale, the merchant accepts several different credit card numbers as payment. The charges are authorized by the credit card authorization centre and confirmation numbers are received. The generators are shipped. Two weeks later, the merchant discovers the credit card authorization centre has charged back the value of the purchase, citing fraud.

Illustration 19-3: While the vast majority of commercial Internet transactions are consummated without incident, increasingly fraudsters will contract for goods using counterfeit or altered financial instruments, or unauthorized or stolen payment card data as payment. By the time the merchant becomes aware the payment has been rejected, the goods may have already been shipped, received and disposed of by the fraudster. Recovery of amounts lost is extremely difficult and generally not possible.

- After initially contacting a company by electronic mail, a fraudulent buyer will offer a corporate cheque or money order or draft in excess of the sale amount and ask that the seller return the difference by wire transfer.

Illustration 19-4: A wholesaler receives e-mail from a buyer who places an order for \$25,000 worth of goods. The buyer claims to be with an established company with international operations. The wholesaler receives a “certified company cheque” for \$50,000 and contacts the buyer by e-mail to report the “error”. The buyer instructs the seller to simply deposit the cheque, keep the monies owed and wire transfer the balance to an outlet of a money-wire service. Cautious the cheque could be worthless, the seller waits until it clears the bank. Assuming all is well, the seller wire transfers the extra funds as instructed and ships the goods. Two

weeks later, the bank reverses the \$50,000 payment. The cheque was counterfeit and was not detected by the company named on the cheque until its monthly reconciliation was completed.

- Fraudsters know that the Internet provides safe and efficient ways to market stolen goods.

Illustration 19-5: Online auctions are used to sell merchandise that fraudsters already have stolen or fraudsters may act as brokers for theft rings in different regions of the world that may directly ship stolen goods to auction winners.

- The Internet attracts fraudsters who use new technologies to maintain anonymity.

Illustration 19-6: Fraudsters worldwide use Internet “pharming”, that is look-alike, false websites aimed at redirecting a legitimate website’s traffic to a fraudulent website.

Illustration 19-7: Technologies and transnational fraud are linked when fraudsters use call-forwarding, anonymous re-mailers and similar means in an effort to conceal their identities and locations and avoid tracing by law enforcement.

- Technologies, including transportation, information and communication technologies are increasingly being used more effectively by fraudsters to share expertise from one region to another, to identify, contact and deceive victims, to avoid detection and to conceal proceeds.

Illustration 19-8: A growing variety of fraud schemes depend substantially on technological elements and exploit technological vulnerabilities, including telemarketing fraud, Internet fraud, credit and debit card fraud, and financial institution fraud. The more sophisticated transnational fraud schemes have tended to take advantage of cutting-edge developments in technology to reach potential victims, including cellular telephony, Voice Over Internet Protocol (VOIP), and Internet-based communication.

Advice:

- Be aware that the scope of fraud conducted through the Internet and related technologies and encountered by the commercial community is very broad, reflecting the full diversity of legitimate commercial activity, and that international orders are particularly susceptible in this regard.
- Exercise caution when entering Internet sales transactions that involve high-value merchandise, which are often involved in Internet fraud schemes, including online auctions or online retail sales, and credit-card fraud schemes.
- Insist on receiving the appropriate amount of money for a sale and do not wire transfer cash back to a buyer based on an “overpayment” that was not made in cash.
- When cheques, money orders, drafts or similar financial instruments are used as payment, certified or otherwise, verify the amount and check the

number and signature if possible using direct communication channels outside the Internet and electronic mail. Inquire with the postal service or issuing bank to verify that the document numbers or amounts are legitimate.

- Beware of common misuses of technology, such as e-mail “phishing”, where victims are induced to provide their own identity or financial information to fraudsters masquerading as commercial or government authority figures, or “pharming” where identical but false websites redirect a legitimate website’s traffic to a fraudulent website.

See also: Indicator 7 — Overly Complex or Overly Simplistic Transactions; Indicator 8 — Frustration of Due Diligence; Indicator 18 — Inappropriate Requests for Information Disclosure; Indicator 20 — Pyramid and Multi-Level Marketing Schemes; Indicator 21 — Frauds Involving Goods and Services; Addendum 1 — Performing Due Diligence.

Indicator 20: Pyramid and Multi-Level Marketing Schemes

A fraudster may seek to recruit new sales personnel to sell merchandise or financial products. The sales recruit will be asked to pay (or “invest”) a fee to join the programme and will then recruit others, who will also pay a fee, from which the fraudster and the earlier recruit will receive commissions. The recruit will typically be promised large returns, both from the sales and the recruitment fees.

Explanation:

Manufacturers and marketing companies typically establish distribution networks and recruit sales forces to service them. Some may offer incentives to sales recruits to recruit other sales personnel to work for them and share their sales commissions. Such a multi-level marketing structure may be legitimate, but fraudsters also use such arrangements to facilitate fraud.

The sales structure is essentially in the shape of a pyramid with the fraudster at the top and successive layers of salespersons or victims beneath him. The objective is to obtain as large a sales force as possible to maximize fees. Additionally, the fraudster may require the recruit, and his or her recruits in turn, to purchase large quantities of product that may prove difficult to sell if the sales territory is saturated with sales personnel. Typically, the fraudster and a very few early recruits at the top of the pyramid are enriched, while the later recruits lose most or all of their investment when the pyramid ultimately collapses.

Regardless of the underlying product, service, investment or programme, any “profit” is illusory and is paid as the result of the pyramid type scheme. Such “profit” represents only principal or invested capital returned to the investor from his or her own capital or funds contributed by other investor-victims. Trans-national multi-level, mass-marketing frauds use multiple jurisdictions to conduct different aspects of the schemes and have been known to use communication technologies that create the appearance that they are located in other nations.

Instances and Examples:

- At times the structure of the pyramid is itself the incentive and induces victims to provide references for the programme.

Illustration 20-1: For a fee, a merchandise distributor offered prospective distributors the opportunity to recruit new salespeople and receive direct and override commissions for each new salesperson recruited. The prospective distributor must purchase a specified amount of merchandise that it may re-sell to its salesman.

Illustration 20-2: Marketing various products, a company offered prospective distributors direct and override commissions for recruiting salespersons under its supervision. The prospective distributor must agree to purchase a large quantity of goods, which may be resold to its salesmen. The company does not have specific retail sales targets and commissions are computed on wholesale sales. Additionally, the company will not accept the return of unsold merchandise.

- At other times, fraudsters use multi-level marketing structures in the background, relying on the underlying offer to entice recruits while changing details of the enticement to suit different regions of the world, consumer trends and categories of victims.

Illustration 20-3: A promoter of a high-yield, no-risk, exotic financial instrument “roll trading programme” offered wealthy prospective investors 100 percent per month returns and “bonuses” for introducing new investors, who would also be entitled to bonuses for introducing others.

Illustration 20-4: In a consumer-cantered economy, a promoter used newspaper advertisements, telephone messages and “investment seminars” at hotels and shopping malls to contact new recruits to an investment that promised returns up to 2,500 percent per month within three months and 62,500 percent within six months with “no risk”.

Illustration 20-5: In a developing economy, where the right of private ownership was relatively new, a promoter lured investors from new economy employees, offering “undivided interest” in remote teak tree plantations or unidentifiable or even nonexistent individual teak trees.

Illustration 20-6: In a transitional economy, a promoter enticed unemployed urban citizens with promises of 60 percent returns in exchange for the right to breed insects for medicinal purposes.

- Conditions such as major economic development or transitions can generate substantial increases in pyramid type, multi-level, mass-marketing frauds, that seek to take advantage of the confusion between old and new economic principles and specific activities such as the privatization of State-owned operations.

Illustration 20-7: One nation attempting to make the transition from central to private ownership suffered extreme economic failure as a result of a series of nationwide, privately run, pyramid type lottery frauds.

Advice:

- When a programme requires the purchase of expensive inventory and marketing materials, contact the appropriate regulatory authority for information on the programme and perform basic due diligence considering the quality and cost of inventory, reputation of the supplier, and the like.
- Be wary of programmes that offer commissions or high rates of return to prospective investors for recruiting new investors, who may, in turn, recruit others.
- It is a signal of potential fraud when the promoter offers only a token amount of product while promising large returns if the prospective investor increases the number of new recruits and the programme does not permit the return of unsold merchandise.
- Pyramid promoters often offer “asset enhancement programmes”. It is a signal of potential fraud when the promoter offers “above market returns” or programmes based on exotic financial instruments, investments or products to participants not familiar with the market for the underlying instruments, investments or products, when the programme is offered at what is billed as a “charity event” or “benefit”, or when the programme requires an initial entry fee.

See also: Indicator 5 — Disproportionate Returns; Indicator 8 — Frustration of Due Diligence; Indicator 9 — Corrupted Incentives; Indicator 13 — Questionable or Unknown Source of Repayment; Indicator 15 — Fraud Based on Abuse of Personal Affinity or Relationships; Indicator 19 — Unsolicited E-mail and Related Misuse of Technology; Addendum 1 — Performing Due Diligence.

Indicator 21: Frauds Involving Goods and Services

Commercial frauds involving goods or services are often facilitated by fraudsters who misrepresent the nature, quality, or value of goods or services to be delivered or that are the subject of investment.

Explanation:

Sales of goods and services are important components of international trade. Fraudsters often take advantage of these activities to commit fraud by entering into the transaction with no intention of performing their obligations, or by deciding to do so during the course of the transaction. The fraudster promoting the transaction may perpetrate fraud by seriously misrepresenting the goods or services involved, or the purchaser of a product, an investor, or someone relying on the receipt of physical goods may find that the goods are never received or never existed. If goods are received, those that are received or in which investment has been made may differ substantially from the representations of the fraudster, or from the specifications of the transaction. Goods may be of greatly inferior or little value, counterfeit, or may have been tampered with in such a way so as to significantly reduce their value. Similarly, a victim that has contracted for the receipt of services, and paid in advance, might never receive those services.

Instances and Examples:

- The goods that are the subject of the transaction or investment may be of lesser quality or value than as contracted, or the goods may be counterfeit.

Illustration 21-1: Goods such as luxury products, art, antiquities or precious stones, in which a buyer needs special expertise to ascertain their value or their provenance may be misrepresented as being much more valuable than they are or as having a legitimate provenance.

Illustration 21-2: Fraudulent investments have been sought on the basis of an alleged massive projected increase in value of a variety of products, including art, stamps, and even malt whiskey.

Illustration 21-3: Labelling may be changed or affixed to counterfeit products so as to pass them off on unsuspecting purchasers.

Illustration 21-4: Pharmaceuticals or other products sold at greatly reduced rates on the internet and elsewhere may not be genuine products, or they may be black market products being sold to gain proceeds from theft or other crimes.

Illustration 21-5: A fraudster contracts with a buyer for the sale of specifically manufactured goods. After the fraudster has received payment, the buyer discovers that the goods shipped are imitations.

- A fraudster may represent that goods have been shipped or received when, in fact, they have not, or the fraudster may represent that goods exist when they do not.

Illustration 21-6: A fraudster contracts with a buyer to sell the buyer certain goods and both agree that the seller will accept a letter of credit as payment. The seller ships nothing but presents conforming documents to its bank, indicating that goods have been shipped, and the seller's bank pays the contract price.

Illustration 21-7: A fraudster seeks financing from a bank for the manufacture of raw materials into a final product. The fraudster represents that it is already in possession of the raw materials and induces the bank to finance the fraudster, although the bank has never observed the raw materials. The fraudster receives the proceeds of the transaction, although the raw materials do not exist.

- The goods that are received may have been tampered with by the fraudster.

Illustration 21-8: A fraudster contracts to sell certain goods to a buyer, and both parties agree that seller will accept a letter of credit as payment. The fraudster ships the goods in containers, properly marked in conformance with the shipping documents. The fraudster presents conforming documents to the bank to receive payment, based upon delivery of the containers before the buyer discovers that the containers have been packed with scrap metal instead of the contracted goods.

Illustration 21-9: Seals on trucks or on containers of products may be tampered with, the contents of the truck or container removed, and the seals replaced with fraudulent seals.

Advice:

- Before entering a transaction relying on the existence of goods, always ensure that the goods exist as represented.
- Never blindly rely on the self-professed expertise of the promoter of the product, particularly when dealing with goods outside one's personal expertise.
- If products are available for inspection, examine carefully the labelling and quality, or where necessary, have the products examined by a reputable expert.
- When the commodity offered is significantly below its wholesale price, be suspicious: obtain a random sample and have it analyzed or appraised by a reputable expert.
- Know one's counterparty, including performing any due diligence necessary to establish the reliability of the counterparty.
- If products are available for inspection, examine carefully the labelling and quality.

See also: Indicator 3 — Inconsistencies in the Transaction; Indicator 8 — Frustration of Due Diligence; Indicator 19 — Unsolicited E-mail and Related Misuse of Technology; Addendum 1 — Performing Due Diligence.

Indicator 22: Securities Fraud and Market Abuse

Commercial frauds often involve the sale of securities that are not registered by persons who are not licensed to sell them under applicable securities laws and regulations, or where market abuse or manipulation occurs.

Explanation:

The issuance and sale of securities is an essential component of modern finance and commerce, and securities market regulators in most countries are very active in preventing and prosecuting securities fraud and financial market abuse. In part, they do so by requiring that securities be registered and that persons selling them be licensed. Fraudsters often seek to manipulate these perceptions of safety engendered by regulatory systems and to reap the profits that the abuse of securities markets can offer. In addition to the manipulation of the market via insider trading, investors may find themselves subject to high pressure sales tactics regarding certain securities, or they may fall victim to so-called “pump and dump” schemes that artificially increase the price of the security and the demand for it, thus allowing the fraudster to sell out at the inflated price. Further, funds and assets may be siphoned off by the management of a particular publicly-traded company at the expense of non-controlling shareholders. In general, a high percentage of securities cases involve one or more of these basic violations: unlicensed brokers, unregistered or fictitious securities or fraudulent misrepresentations or omissions, unsuitable

recommendations, excessive trading or “churning”, market manipulation, or outright theft of funds and assets by corporate insiders.

Instances and Examples:

- Fraudulent or fictitious securities are promoted in a variety of ways that imitate and expand on the marketing of legitimate securities:

- Advertisements or newspaper articles are encouraged or placed containing false or misleading information;

Illustration 22-1: Articles and advertisements were published suggesting that there was a current value for once valid World War I era bonds that had been demonetized by statute and by international treaty.

- Unsolicited contacts are made;

Illustration 22-2: Unsolicited phone calls, faxes, letters or e-mails are received from persons presenting themselves as stock promoters or brokerage firms and advocating that the recipient act immediately on a ‘hot’ tip.

- High pressure sales tactics are used, and there is often an element of urgency connected with the investment.

Illustration 22-3: Promotions suggest that a unique profit opportunity will be lost unless it is acted upon immediately by the investor since only a limited number of people can invest. Allegations may be made that the market is only open for a limited time.

- There are assurances of little or no risk;
- And often there is reference to so-called “secret markets” in which “trading” occurs.

- Fraudulent or fictitious securities violate securities laws and regulations and frustrate their scheme of regulation:

- The securities are not properly registered;

Illustration 22-4: The fraudster may allege that registration of the securities in this instance is not required;

- The person selling the fraudulent or fictitious security often is not licensed as a securities broker;
- Or misrepresentations and omissions of material information are made about the profits, risks, and fees associated with investments represented by the securities.

- Fraudulent securities often are exotic or have exotic features or incredible stories associated with them in order to explain their alleged value.

Illustration 22-5: Metal boxes containing securities allegedly worth billions of US dollars in so-called “Federal Reserve Notes” were newly discovered in the Philippines after being hidden by an infamous warlord at the end of World War II.

- Account statements or transactions statements that have an irregular appearance, suggesting possible forgery to disguise theft.

Advice:

- Only deal in securities through reputable channels and brokers.
- Reject the proposal or contact the appropriate securities regulator to make sure that the salesperson is properly licensed and that the security itself meets applicable registration requirements.
- Discuss any proposed investment with one's own independent financial adviser prior to investing, particularly when the price of a particular financial instrument seems to be increasing or decreasing rapidly.
- Review carefully all account statements for signs of irregularities that may suggest a falsified statement intended to disguise theft.
- Independently verify accounts with the financial house said to hold them.
- When the security cannot be understood without a complex and convoluted explanation with unusual characteristics, it should be rejected or independently verified.

See also: Indicator 8 — Frustration of Due Diligence; Addendum 1 — Performing Due Diligence.

Indicator 23: Misuse of Insolvency Proceedings

The insolvency process can be used as a mechanism to facilitate commercial fraud by facilitating the improper transfer of assets, by obtaining investment in the insolvent entity through misrepresentation, or by filing or selling false claims.

Explanation:

Most legal systems have insolvency legislation to enable companies or individual entities in business to restructure debt through reorganization or liquidation proceedings. Those insolvency regimes provide for substantial oversight in the insolvency process through judicial or administrative supervision if properly used. The insolvency processes serve important commercial and policy needs for businesses experiencing financial difficulties.

While frauds may often result in the filing of an insolvency proceeding relating to the victim, fraudulent schemes also use the legal process related to insolvency to mask or facilitate commercial fraud, and to use the credibility of the insolvency process to provide a false sense of security to intended victims. Fraudsters use the insolvency process to misrepresent that the insolvency court or representative has reviewed and approved of representations purportedly made on behalf of the insolvent entity. Fraudsters also can use the insolvency process to hide the improper transfer of assets or to file and sell false claims. Finally, the insolvency process can be used to provide credibility for the insolvent entity, so that it may obtain additional goods, services, or credit.

Instances and Examples:

- The insolvency process can be used to hide assets from existing creditors.

Illustration 23-1: Before entering insolvency, an entity may shift assets from one jurisdiction to another in order to hide the assets or to establish a new business operation. Creditors of the entity are then denied recovery, because the entity has insufficient assets to pay prior debts.

Illustration 23-2: Prior to an entity entering insolvency, the principals of the entity transfer assets to themselves or to other insiders, thus denying available funds to creditors of the entity.

- The fraudster may misrepresent the value of assets or business enterprises of the insolvent entity.

Illustration 23-3: Fraudster undervalues the assets of an insolvent entity, so that creditors are induced to accept substantially less than full value of the debt owed.

Illustration 23-4: Fraudster may overvalue assets of an insolvent entity, knowing that victims will believe the fraudster's valuations have been reviewed by or verified by the court or insolvency representative. Victims then invest in the insolvent entity, believing that the entity's financial position is better than it is.

- False claims may be filed in the insolvency proceeding to defraud creditors or potential investors.

Illustration 23-5: Once an entity enters insolvency proceedings, the principals of the entity file false claims, inducing the court and insolvency representative to distribute less to valid creditors as well as portions of the assets to the principals.

Illustration 23-6: A fraudster files false claims against an insolvent entity and sells the claims at a discount to victims who, believing the claims to be valid, attempts to collect from the insolvent entity.

- The insolvency proceedings may be used to lend credibility to the insolvent entity.

Illustration 23-7: A fraudster induces a victim to provide the insolvent entity with goods, services, or credit. Victim is told that the court or insolvency representative has guaranteed payment or otherwise assured the victim of repayment by giving its authorization or approval, when in fact it has not.

Illustration 23-8: Another fraud can take place when a transaction requires a prepayment, and the other party claims that it is insolvent subsequent to the receipt of the prepayment.

Advice:

- Remember that insolvent entities are in insolvency proceedings as a result of being unable to pay existing creditors or of failing in its business enterprise. Any proposed transaction with or investment in the insolvent entity must be carefully reviewed prior to any investment made.

- Always exercise proper due diligence and independently investigate any representations of value by the insolvent entity before extending any additional credit or providing goods and services on credit.
- Because insolvency proceedings are generally a matter of public record, the insolvency proceedings should be reviewed to verify any representations supposedly made by an insolvency court or insolvency representative.
- Never suspend the exercise of due diligence on a mere assertion by a counterparty that an insolvency court or insolvency representative has approved or authorized a transaction or investment.
- Carefully review any transfers of assets by the insolvent entity both prior to and during the insolvency proceeding to determine if such transfers are legitimate.

See also: Indicator 8 — Frustration of Due Diligence; Addendum 1 — Performing Due Diligence.

Addendum 1: Performing Due Diligence

The appropriate performance of due diligence will depend upon the particular circumstances of the transaction in issue, but it is possible to articulate some general rules that should be followed in ascertaining the bona fides of a transaction and of counterparties. Remember that this list contains only general guidance, and that other sources should be considered for more detailed assistance, for example, the website of the US Federal Trade Commission (www.ftc.gov); the website of an international consortium of consumer protection agencies, Consumer Sentinel (www.consumer.gov); another international consortium, Econsumer (www.econsumer.gov); or the European Union consumer website (http://ec.europa.eu/consumers/index_en.htm).

1. Determining how one was chosen for contact

- If the investor did not initiate the contact, inquire as to how the counterparty obtained one's name and contact information
- Inquire as to why the counterparty is contacting the particular investor. Why does the counterparty think the investor is appropriate for a business transaction? Vague or general answers indicate that the counterparty does not have a good basis for determining one's suitability for the transaction.

2. Verifying the counterparty

- Always seek contact numbers, information and the identity of the counterparty and its representatives independently of the information provided by the promoter of the investment, via Internet, telephone books, business organizations, the press, library materials, or the like. Do not rely on telephone numbers, websites, addresses or the views of professionals provided by the promoter of the investment in performing due diligence.
- When dealing with a professional, ascertain from the relevant professional organization whether the professional is properly registered and qualified by the organizations and the history of the professional, including any complaints made or charges brought against that professional.

- If possible, check the names of counterparties and promoters for criminal history or complaints with criminal fraud authorities in one's jurisdiction. Remember that aliases may be used by fraudsters.
- Remember that fraudsters may work in teams, and corroboration by other people, particularly those suggested by the promoter, may not be sufficient to protect oneself.

3. Recognizing sales tactics

High pressure

- Do not abandon the completion of thorough due diligence when faced with emotional appeals, such as those purporting to involve humanitarian crises.
- Do not succumb to time pressures such as the need to invest or purchase immediately because the opportunity is about to be lost. If the deal is that good, the promoter would not need to contact individual investors. If one is discouraged from conducting due diligence due to time pressures, do not proceed with the transaction.

Expectations

- Check the key facts of the transaction, including predictions of rates of return, against current economic events, such as the price or amount of a particular commodity in issue, or the normal trading patterns of the commodity.

4. Identifying the product

- Determine the product that is being sold. Sometimes the product is a service or an intangible legal right disguised as a physical product.
- Intangible rights such as options to buy, time share arrangements, rights to lease and the like are very difficult to verify as to their existence. Extra due diligence will be necessary to verify their authenticity.
- Products that are stored in a different local jurisdiction or overseas are easily falsified and will also need additional due diligence.

5. Identifying the nature of the transaction

- Determine what one is being asked to do: make a down payment, pay a finder's fee, enter into a "swap" transaction, set up an escrow, purchase a letter of credit or similar events that are only part of the transaction. Many of these transactions do not transfer any property rights to the customer, but are preliminary at best.
- Consider using a trusted broker as a "middleman" to hold funds pending contract performance or delivery of goods.
- Verify that any funds sent are returnable if the transaction does not complete.

6. Determining the mechanics and documentation of the transaction

How funds are handled

- Determine where funds are being sent for payment and verify the recipient institution. Is it a reputable financial institution in a reputable jurisdiction

or is it an offshore account? Legal remedies in offshore centres are generally weak for individual investors.

- If the money is being held in escrow or in a letter of credit, is the financial institution in good standing and with a good reputation?
- Verify signatures, accounts, and other documentary information provided by contacting, for example, the organization on whose letterhead the information is printed, or the person who has purportedly signed the document.
- Any security vehicles or documents provided, such as letters of credit, guarantees, or the like, should be verified by calling the other parties mentioned in the document to ascertain their validity.

How to communicate with the counterparty

- The counterparty should be easily accessible by phone, mail or e-mail. The information should be independently verifiable.
- Personal visits to the counterparty's offices should be available to get an idea as to the nature of the counterparty. Care should be taken that appearances are deceiving.

What information is exchanged with counterparty

- Care should be taken as to what information is given to the counterparty. Business information is appropriate but personal information is not in a normal commercial transaction.
- Personal information to financial institutions such as securities and commodities brokers should only be given after verifying their registration and good standing with the relevant regulatory authorities.

8. Researching the parties, products and transactions

- Increasingly, materials on on-going fraudulent schemes and warnings regarding domestic or foreign fraud areas are being publicized by regulatory authorities and business and consumer organizations. Efforts should be made to locate such materials either online or via local business organizations.
- Follow up on any uneasiness one may have — for example, a telephone area code that does not fit the purported location, or facts that do not make sense.
- Engage in some comparison shopping for similar products or transactions, if possible.
- If dealing with products, try to obtain a sample to have it analyzed, or try to have the item in question appraised by a qualified and independent party.
- Start one's inquiry on a regional basis, looking to domestic private and governmental organizations for information, then broaden the approach to encompass cross-border review, into jurisdictions referred to in the documentation or by the promoter as well as those that have not been mentioned, which may have been the site of previous frauds.

- If a very large investment is being considered, hire the services of professionals to conduct due diligence on the promoter and the proposal.
- Even if the relationship is an ongoing one, treat every new investment or significant transaction with the same caution and the same approach to due diligence.

VII. CASE LAW ON UNCITRAL TEXTS (CLOUT)

The secretariat of the United Nations Commission on International Trade Law (UNCITRAL) continues to publish court decisions and arbitral awards that are relevant to the interpretation or application of a text resulting from the work of UNCITRAL. For a description of CLOUT (Case Law on UNCITRAL Texts), see the users guide (A/CN.9/SER.C/GUIDE/1/Rev.1), published in 2000 and available on the Internet at www.uncitral.org.

A/CN.9/SER.C/ABSTRACTS may be obtained from the UNCITRAL secretariat at the following address:

UNCITRAL secretariat
P.O. Box 500
Vienna International Centre
A-1400 Vienna
Austria

Telephone (+43-1) 26060-4060 or 4061

Telex: 135612 uno a

Telefax: (+43-1) 26060-5813

E-mail: uncitral@uncitral.org

They may also be accessed through the UNCITRAL homepage on the Internet at www.uncitral.org.

Copies of complete texts of court-decisions and arbitral awards, in the original language, reported on in the context of CLOUT are available from the secretariat upon request.

VIII. TECHNICAL ASSISTANCE TO LAW REFORM

Note by the Secretariat on technical cooperation and assistance

(A/CN.9/627) [Original: English]

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I. Introduction

1. The United Nations Commission on International Trade Law (UNCITRAL) plays an important role in developing the legal framework for international trade and investment through its mandate to prepare and promote the use and adoption of legislative and non-legislative instruments in a number of key areas of trade law, including: sales; dispute resolution; government contracting; banking and payments; security interests; insolvency; transport; and electronic commerce. Those instruments are widely accepted, offering solutions appropriate to different legal traditions and to countries at different stages of economic development and include:

(a) In the area of sale of goods, the United Nations Convention on Contracts for the International Sale of Goods (CISG)¹ and the United Nations Convention on the Limitation Period in the International Sale of Goods;²

(b) In the area of dispute resolution, the Convention on the Recognition and Enforcement of Foreign Arbitral Awards³ (the new York convention, a United Nations convention adopted prior to the establishment of the Commission, but actively promoted by it), the UNCITRAL Arbitration Rules,⁴ the UNCITRAL Conciliation Rules,⁵ the UNCITRAL Model Law on International Commercial Arbitration and revised articles,⁶ the UNCITRAL Notes on Organizing Arbitral Proceedings,⁷ and the UNCITRAL Model Law on International Commercial Conciliation;⁸

(c) In the area of government contracting, the UNCITRAL Model Law on Procurement of Goods, Construction and Services,⁹ the UNCITRAL Legislative Guide on Privately Financed Infrastructure Projects¹⁰ and the UNCITRAL Model Legislative Provisions on Privately Financed Infrastructure Projects;¹¹

¹ 11 April 1980, United Nations, *Treaty Series*, vol. 1489, p. 3; *Official Records of the United Nations Conference on Contracts for the International Sale of Goods, Vienna, 10 March-11 April 1980* (United Nations publication, Sales No. E.82.V.5), part. I.

² *Official Records of the United Nations Conference on Prescription (Limitation) in the International Sale of Goods, New York, 20 May-14 June 1974* (United Nations publication, Sales No. E.74.V.8), part I; United Nations, *Treaty Series*, vol. 1511, pp. 77 and 99; *UNCITRAL Yearbook 1980*, part three, chap. I, sect. C.

³ United Nations, *Treaty Series*, vol. 330, No. 4739.

⁴ *Official Records of the General Assembly, Thirty-first Session, Supplement No. 17 (A/31/17)*, para. 57; *UNCITRAL Yearbook 1976*, part one, chap. II, sect. A.

⁵ *Official Records of the General Assembly, Thirty-fifth Session, Supplement No. 17 (A/35/17)*, chap. V, sect. A, para. 106; *UNCITRAL Yearbook 1980*, part three, chap. II.

⁶ *Official Records of the General Assembly, Fortieth Session, Supplement No. 17 (A/40/17)*, annex I; *UNCITRAL Yearbook 1985*, part three, chap. I; *Official Records of the General Assembly, Sixty-first Session, Supplement No. 17 (A/61/17)*, annex I.

⁷ *UNCITRAL Yearbook 1996*, part three, chap. II.

⁸ *Official Records of the General Assembly, Fifty-seventh Session, Supplement No. 17 (A/57/17)*, annex I; *UNCITRAL Yearbook 2002*, part three.

⁹ *Official Records of the General Assembly, Forty-ninth Session, Supplement No. 17 (A/49/17)*, annex I; *UNCITRAL Yearbook 1994*, part three, chap. I.

¹⁰ United Nations publication, Sales No. E.01.V.4, A/CN.9/SER.B/4.

¹¹ *Official Records of the General Assembly, Fifty-eighth Session, Supplement No. 17 (A/57/17)*, annex I.

(d) In the area of banking and payments, the United Nations Convention on International Bills of Exchange and International Promissory Notes,¹² the UNCITRAL Model Law on International Credit Transfers,¹³ and the United Nations Convention on Independent Guarantees and Standby Letters of Credit;¹⁴

(e) In the area of security interests, the United Nations Convention on the Assignment of Receivables in International Trade;¹⁵

(f) In the area of insolvency, the UNCITRAL Model Law on Cross-Border Insolvency¹⁶ and the UNCITRAL Legislative Guide on Insolvency Law;¹⁷

(g) In the area of transport, the United Nations Convention on the Carriage of Goods by Sea (Hamburg Rules),¹⁸ and the United Nations Convention on the Liability of Operators of Transport Terminals in International Trade;¹⁹ and

(h) In the area of electronic commerce, the UNCITRAL Model Law on Electronic Commerce,²⁰ the UNCITRAL Model Law on Electronic Signatures²¹ and the United Nations Convention on the Use of Electronic Communications in International Contracts (ECC).²²

2. Technical cooperation and assistance activities aimed at promoting the use and adoption of its texts is one of UNCITRAL's priorities, pursuant to a decision taken at its twentieth session (1987),²³ and are particularly useful for developing countries and economies in transition lacking expertise in the areas of trade law covered by the work of UNCITRAL. Since trade law reform, based on harmonized international instruments, has a clear impact on the ability to participate in international trade, the Secretariat's technical cooperation and assistance work aimed at promoting use and adoption of texts can facilitate economic development.

3. In its resolution 60/20 of 23 November 2005, the General Assembly reaffirmed the importance, in particular for developing countries and economies in transition, of the technical cooperation and assistance work of the Commission in the field of international trade law and reiterated its appeal to the United Nations Development Programme and other bodies responsible for development assistance, such as the World Bank and regional development banks, as well as to Governments in their bilateral aid programmes, to support the technical cooperation and assistance

¹² *UNCITRAL Yearbook 1988*, part three, chap. I; General Assembly resolution 43/165, annex.

¹³ *Official Records of the General Assembly, Forty-seventh Session, Supplement No. 17 (A/47/17)*, annex I.

¹⁴ New York, 11 December 1995, United Nations, *Treaty Series*, vol. 2169, p. 163; *Official Records of the General Assembly, Fiftieth Session, Supplement No. 17 (A/50/17)*, annex I.

¹⁵ *UNCITRAL Yearbook 2002*, part three; General Assembly resolution 56/81, annex.

¹⁶ *UNCITRAL Yearbook 1992*, part three, chap. I.

¹⁷ *Official Records of the General Assembly, Fifty-ninth Session, Supplement No. 17 (A/59/17)*, para. 55.

¹⁸ Hamburg, 31 March 1978 United Nations, *Treaty Series*, vol. 1695, p. 3; *Official Records of the United Nations Conference on the Carriage of Goods by Sea, Hamburg, 6-31 March 1978* (United Nations publication, Sales No. E.80.VIII.1), document A/CONF.89/13, annex I.

¹⁹ A/CONF.152/13, annex.

²⁰ *Official Records of the General Assembly, Fifty-first Session, Supplement No. 17 (A/51/17)*, annex I.

²¹ *Ibid.*, *Fifty-sixth Session, Supplement No. 17 (A/56/17)*, annex II.

²² New York, November 2005, General Assembly resolution A/RES/60/21, annex.

²³ *Official Records of the General Assembly, Forty-second Session, Supplement No. 17 (A/42/17)*, para. 335.

programme of the Commission and to cooperate and coordinate their activities with those of the Commission. The General Assembly also stressed the importance of bringing into effect the conventions emanating from the work of the Commission to further the progressive harmonization and unification of private law, and to this end urged States that have not yet done so to consider signing, ratifying or acceding to those conventions.

4. This note lists the technical cooperation and assistance activities of the Secretariat subsequent to the date of the previous note submitted to the Commission at its thirty-ninth session in 2006 (A/CN.9/599 of 4 April 2006), and reports on the development of resources to assist technical cooperation and assistance activities.

II. Technical cooperation and assistance activities

5. Technical cooperation and assistance activities undertaken by the UNCITRAL Secretariat promote the adoption of UNCITRAL legislative texts, including conventions, model laws and legislative guides and include providing advice to States considering signature, ratification or accession to UNCITRAL conventions, as well as to States that are in the process of revising their trade law and considering adoption of an UNCITRAL model law or use of a UNCITRAL legislative guide. They also support implementation of these texts and their uniform interpretation. Technical cooperation and assistance may involve: undertaking briefing missions and participating in seminars and conferences, organized at both regional and national levels, on UNCITRAL texts; assisting countries to review existing legislation and assess their need for law reform in the trade field; assisting with the drafting of national legislation to implement UNCITRAL texts; assisting international and bilateral development agencies to use UNCITRAL texts in their law reform activities and projects; providing advice and assistance to international and other organizations, such as professional associations, organizations of attorneys, chambers of commerce and arbitration centres, on the use of UNCITRAL texts; and organizing training activities to facilitate the implementation and interpretation of modern legislation based on UNCITRAL texts by judiciaries and legal practitioners.

A. Activities addressing multiple topics

6. A number of technical cooperation and assistance activities undertaken since the last report covered several of the topic areas noted in paragraph 1 above.

7. In the context of providing support for ongoing peace-building activities, the Ministry of Foreign Affairs of Liberia requested the Office of Legal Affairs/Treaty Section to coordinate the participation of a number of substantive offices of the United Nations (OLA/International Trade Law Division, United Nations Office of Drugs and Crime, Office of the High Commissioner for Human Rights) and the International Committee of the Red Cross in a seminar on treaty implementation promoted by the Result-Focused Transitional Framework for Liberia Implementation and Monitoring Committee (RFTF-RIMCO) (a United Nations Development Programme-World Bank joint initiative) (Monrovia, Liberia, 10-14 July 2006).^{*} The purpose of the mission was to support, in accordance with a

^{*} Denotes activities funded by the UNCITRAL Trust fund for Symposia.

wish of the Secretary-General of the United Nations, the Liberian Government in its implementation of the obligations resulting from the treaty actions undertaken in September 2005, including treaties in the field of international trade law on sale of goods, transport and international commercial arbitration.

8. At the regional level, the Secretariat participated at:

(a) 3rd Association of Southeast Asian Nations (ASEAN) Law Forum “International Trade Law Development among ASEAN countries” (Nongkhai, Thailand and Vientiane, Laos, 9-14 September 2006)* focussing on international trade law development among ASEAN Countries. UNCITRAL promoted the use of UNCITRAL instruments as a basis for legal harmonization among ASEAN countries, in line with the Action Plan drawn up by the ASLOM (ASEAN Law Officials Meeting) Working Group on Establishing the Modalities for Harmonization of ASEAN Trade Laws; and

(b) Workshop on Harmonisation of Business Law in Africa, organized by the African Union in cooperation with the African Law Institute (Tswane, South Africa, 12-14 December 2006).* The objective of the workshop was to elaborate a general framework for harmonization of business law in Africa and to recommend a long term work programme to be adopted by relevant organs of the African Union. UNCITRAL recommended inclusion of UNCITRAL instruments in that programme, including in the areas of dispute resolution, electronic commerce, secured transactions and cross-border insolvency.

9. At the country level, in collaboration with the International Trade Centre (ITC), the Secretariat participated at a workshop on multilateral trade treaties within the European Union Asian Trust Fund funded project “Upgrading Vietnam’s Legal Multilateral Trade Framework”, in conjunction with the Ministry of Trade of Viet Nam (Hanoi, Viet Nam, 7-11 October 2006).* The goal of the workshop was to provide the Vietnamese partners with an overview of international agreements relating to trade law, so as to start a process aimed at enhancing the participation of the country in those agreements and assist in improving the overall framework for international trade. This is in line with the ASEAN regional initiative referred to in paragraph (a) above.

10. The Secretariat held a joint meeting with representatives of Italian Ministries in order to present UNCITRAL objectives, policies and activities and with the Ministry of Foreign Affairs, discuss a number of draft UNCITRAL technical cooperation and assistance projects and explore opportunities for funding (Rome, Italy, 9-10 October 2006).*

11. The Secretariat held consultations with Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) concerning areas of possible technical legal assistance cooperation between GTZ and UNCITRAL, including projects in which UNCITRAL texts might form the basis of law reform activities, focussing upon the Balkans and Central Asia (Frankfurt, Germany, 26 January 2007).* Further discussions are taking place concerning possible projects in the areas of sale of goods, dispute resolution and insolvency.

12. To provide a briefing on UNCITRAL’s current legislative activities, the Secretariat organized, in conjunction with the United Nations Institute for Training and Research (UNITAR), a two-day seminar for Permanent Missions accredited to the United Nations Office at Vienna (Vienna, Austria, 21-22 November 2006).

45 representatives from 35 Permanent Missions attended. Briefings on various working group topics are regularly being offered in Vienna.

B. Sale of goods

13. The Secretariat has been particularly active in promoting adoption of the CISG, at the regional level, as well as through contact with Permanent Missions to the United Nations in Vienna, Geneva and New York and directly with relevant officials in selected States. Regional activities included providing a seminar, in cooperation with the Ministry of Justice of Thailand, (Bangkok, Thailand, 9-11 August 2006)* attended by officials from regional countries, which was followed by a workshop with Thai government officials on draft CISG legislation. Activities at the country level included participation at a conference at Istanbul Bilgi University, Turkey (16-19 November 2006) on “United Nations Convention on Contracts for the International Sale of Goods — what challenges for Turkish sales law?”.

14. Assistance was also provided to States in the final stage of the adoption process, with particular regard to formulation of reservations and the deposit of instruments of consent to be bound. Since the last report, the CISG has been adopted by El Salvador, Montenegro and the former Yugoslav Republic of Macedonia.

C. Dispute resolution

15. The Secretariat has promoted adoption of the texts relating to arbitration and conciliation through participation in activities organized both on a regional basis and with individual countries, as well as activities organized by arbitral institutions. Regional activities included:

(a) Participating in a symposium organized with the International Trade Centre (ITC) (Chamonix, France, 16-20 May 2006),* on “Managing Commercial Dispute Resolution Centres”;

(b) Participating in the Advanced Training Course on Managing Investment Disputes, organized and funded jointly by the General Secretariat of the Organization of American States (OAS) and the Secretariat of the United Nations Conference on Trade and Development (UNCTAD) (Puebla, Mexico, 11-18 October 2006).* The programme was directed at government officials responsible for negotiating bilateral investment protection agreements. UNCITRAL addressed use of the UNCITRAL Arbitration Rules and execution of awards under the New York Convention;

(c) Providing a regional seminar involving Viet Nam, Cambodia, Myanmar, Thailand and Lao People’s Democratic Republic (Bangkok, Thailand, 8 August 2006)* on the UNCITRAL Model Laws on International Commercial Arbitration and International Commercial Conciliation, hosted by the Ministry of Justice of Thailand; and

(d) Participation at a Regional Conference on Alternative Dispute Resolution, Mediation and Third Party Arbitration (Kiev, Ukraine, 23-24 May 2006), sponsored by the United Kingdom Department for International Development.

16. The Secretariat collaborated with a number of arbitral institutions and organizations, participating at:

(a) The 18th Congress of the International Council for Commercial Arbitration (ICCA) (Montreal, Canada, 25-26 June 2006);

(b) A conference organized by the International Chamber of Commerce and the Société de législation comparée (Paris, France, 25-27 September 2006) to present recent work by UNCITRAL in the field of arbitration;

(c) The XXXIII Assembly of the Inter-American Association of Chambers of Commerce (AICO) and Conference of the Inter-American Commission of Commercial Arbitration (CIAC) (Alicante, Spain, 22-25 October 2006); and

(d) The International Arbitration Congress jointly organized by the China International Economic and Trade Arbitration Commission (CIETAC) and the International Commercial Arbitration Court of the Chamber of Commerce and Industry of the Russian Federation (Almaty, Kazakhstan, 1-3 November 2006)* to evaluate progress of commercial arbitration legislation in Central Asian countries. The new legislative provisions on interim measures and preliminary orders adopted as a new chapter IV A of the UNCITRAL Model Law on International Commercial Arbitration were introduced to participants.²⁴

17. Activities related specifically to the anniversary of the UNCITRAL Arbitration Rules and their possible revision included: a conference in Bogota, Colombia (19 September 2006)* and a seminar in Kuala Lumpur, Malaysia, (21-24 November 2006)* hosted by the Kuala Lumpur Arbitration Centre.

18. With respect to the New York Convention, the Secretariat conducted a briefing for countries not yet party to the New York Convention to discuss the Convention and the benefits of its adoption (United Nations Headquarters, New York, 7 February 2007).

D. Procurement

19. In accordance with requests of Working Group I (Procurement), the Secretariat has established links with other organizations interested in procurement to foster cooperation, particular with regard to UNCITRAL's work of revising the UNCITRAL Model Law on Procurement of Goods, Construction and Services, as well as undertaking activities to promote knowledge and acceptance of the Model Law.²⁵ These activities have included:

(a) Participation at an International Conference on Electronic Government Procurement (EGP) organized by the Ministry of Finance, China, the Asian Development Bank and the World Bank to make a presentation on the work of UNCITRAL on electronic procurement (Beijing, China, 26-27 April 2006);

(b) A presentation on UNCITRAL's work on public procurement, including revisions to the UNCITRAL Model Law, at the conference "Public Procurement: Global Revolution III" organized by the School of Law, University of Nottingham (Nottingham, United Kingdom, 19-20 June 2006);

²⁴ See note 6.

²⁵ See documents A/CN.9/575, paras. 52 and 67, and A/CN.9/615, para. 14.

(c) Participation at the 2nd and 3rd Organization Committee meetings (Paris, France, 29 August and 20-21 November 2006), for an International Symposium “Developing Trends in Public Procurement and Auditing” to take place in May 2007, being prepared by the procurement department of the European Space Agency; and

(d) Participation at an Organization for Economic Cooperation and Development (OECD) symposium “Mapping out Good Practices for Integrity and Corruption Resistance in Procurement”, and a forum entitled “Forum for Policy Dialogue with Non-Members: Sharing Lessons on Promoting Good Governance and Integrity in Procurement” (Paris, France, 29 November to 1 December 2006). A result of these activities will be publication, by the OECD, of a Good Practice Report, which will map out good practices, and particular approaches, measures and tools that have proved successful in promoting integrity in public procurement in countries across the world.

E. Security interests

20. The Secretariat participated in a number of activities in Europe to promote adoption of the United Nations Convention on the Assignment of Receivables in International Trade (Receivables Convention) and disseminate information on the draft UNCITRAL Legislative Guide on Secured Transactions, including an International Seminar on the Law of Proprietary Security Rights in the Proposal for a new Hungarian Civil Code (Budapest, Hungary 30 November-2 December)* and international and research seminars in Austria and Switzerland. The Secretariat also gave a presentation on the Receivables Convention to the Istanbul Chamber of Commerce (Istanbul, Turkey, 6 November 2006).

F. Commercial fraud

21. The Secretariat participated at the Project MARC Workshop on crime proofing of EU legislation (Brussels, Belgium, 26 June 2006), which aims to provide a mechanism that will facilitate policymakers to assess whether there is any risk that present and future legislation and regulation may produce opportunities for crime.

G. Insolvency

22. The Secretariat has promoted the use and adoption of insolvency texts, particularly the Model Law on Cross-Border Insolvency, through country specific activities aimed at assisting with the drafting of implementing legislation and regional workshops. For example, at the invitation of the Greek Ministry of Justice, the Secretariat participated in meetings of the Greek Bankruptcy Committee to assist with adoption of the UNCITRAL Model Law on Cross-border Insolvency, including the drafting of implementing legislation (Athens, Greece, 11-14 April 2006 and 3-5 November 2006).

23. At the regional level, the Secretariat participated in several workshops, including:

(a) At the invitation of USAID, a Joint Regional Training Workshop on Theoretical and Practical Aspects of Jurisdiction and the Recognition of Insolvency

Proceedings organized by USAID/Commercial Courts Administration Strengthening Activity (CCASA)/Community Assistance for Reconstruction Development and Stabilization (CARDS) Regional Project 2003 (European Union and Council of Europe) (Belgrade, Serbia, 17-20 April 2006). The workshop was attended by judges and government officials from Albania, Bosnia Herzegovina, Croatia, the former Yugoslav Republic of Macedonia, Romania, Serbia and Montenegro. The workshop discussion included the UNCITRAL Model Law on Cross-Border Insolvency, adopted by Serbia, Montenegro and Romania, as well as the intersection between the Model Law and the European Council (EC) Regulation No. 1346/2000 of 29 May 2000 on insolvency proceedings (EC Regulation); and

(b) Fifth Forum on Asian Insolvency Reform (FAIR), (Beijing, China, 27-28 April 2006)* organized to examine the main policy issues arising in legal and institutional reforms of the Asian insolvency systems in recent years and distil lessons stemming from international guidance, including the UNCITRAL Legislative Guide on Insolvency Law and the UNCITRAL Model Law on Cross-Border Insolvency. 160 participants from 22 countries and 5 international organizations attended.

24. Further adoptions of the UNCITRAL Model Law on Cross-Border Insolvency in 2006, in particular by the United States and Great Britain, raised interest in the text and its interaction with the EC Regulation within the European Union (EU). The Secretariat participated in a number of seminars and conferences in Europe with the aim of promoting adoption of the text by EU Member States as a framework for facilitating coordination of cross-border insolvency proceedings between EU Member States and non-Member States.

25. UNCITRAL co-sponsored the Seventh UNCITRAL/INSOL/World Bank Multinational Judicial Colloquium (Cape Town, South Africa, 17-18 March 2007)* with 65 judges and officials attending from 42 countries. The colloquium focused on issues of cross-border cooperation in insolvency cases, including adoption of the UNCITRAL Model Law on Cross-Border Insolvency, and implementing cross-border cooperation and coordination, in particular through the use of cross-border protocols, which is the subject of informal work being undertaken by the Secretariat to compile practical experience with respect to negotiating and using cross-border insolvency protocols.²⁶

H. Electronic commerce

26. The Secretariat has participated in joint activities with national governments and agencies, including a conference on E-Signature law sponsored by the United States Commercial Law Development Programme (CLDP) and the Government of Egypt, at which UNCITRAL made a presentation on the work of UNCITRAL in the area of electronic signatures (Cairo, Egypt, 11-13 July 2006).

27. The Secretariat has been actively promoting adoption of the United Nations Convention on the Use of Electronic Communications in International Contracts (ECC), including by organizing an event dedicated to that Convention in New York on 6 July 2006. Since the last report, the ECC has been signed by China, Lebanon, Madagascar, Paraguay, Senegal, Sierra Leone, Singapore, and Sri Lanka.

²⁶ *Official Records of the General Assembly, Sixty-first Session, Supplement No. 17 (A/61/17)*, paras. 207-209.

I. Assistance with legislative drafting

28. In the context of a programme of commercial law reform for Rwanda (2006 and continuing) the Secretariat has assisted with legislative drafting of various commercial laws based upon UNCITRAL texts, including arbitration, privately financed infrastructure projects, electronic commerce, security interests and insolvency.

III. Coordination activities

29. In accordance with its mandate,²⁷ the UNCITRAL Secretariat participates in a number of the working groups and meetings of other organizations active in the field of international trade law to facilitate coordination of the work being undertaken. Since the last report these have included:

(a) Third session of the UNIDROIT Advisory Board preparing a model law on leasing (Rome, Italy, 3-5 April 2006);

(b) Governing Council of UNIDROIT (Rome, Italy, 7-10 May 2006);

(c) First Session of the Working Group for the preparation of an additional chapter to the UNIDROIT Principles of International Commercial Contracts (Rome, Italy, 29 May-1 June 2006);

(d) A regional workshop for countries negotiating accession to the World Trade Organization (WTO)/WTO Agreement on Government Procurement (GPA) (Geneva, Switzerland 26-30 June 2006);

(e) International Workshop on Collateral Reform and Access to Finance, organized by the European Bank for Reconstruction and Development (EBRD) and the World Bank (London, United Kingdom, 7-10 June 2006);

(f) UNCITRAL-UNIDROIT-Hague Conference on private international law coordination meeting, dealing in particular with coordination between UNCITRAL and UNIDROIT in the field of security interests (Rome, Italy, 18 September 2006);

(g) United Nations Economic Commission for Europe (UNECE) Working Party on Road Transport (Geneva, Switzerland, 18 October 2006);

(h) International Chamber of Commerce (ICC) Banking Committee meeting, to make a presentation on the work of UNCITRAL on transport law (Paris, France, 23 October 2006);

(i) Upon invitation of the International Finance Corporation (IFC), World Bank Group, to participate in the an Experts Workshop on Arbitration and Dispute Resolution and Corporate Governance to discuss the role UNCITRAL plays or can play in setting the stage for solving corporate governance related disputes through mediation mechanisms and providing international guidelines for local institutions (Paris, France, 12-13 February 2007);

(j) ICC task force on E-Business, IT and Telecoms (EBITT) meeting to update members on UNCITRAL's work programme and attend the e-signatures expert group meeting (Paris, France, 20-21 March 2007);

²⁷ General Assembly resolution 2205 (XXI), sect. II, para. 8.

(k) Participation at the multilateral banks' e-government procurement working group meetings (Rome, Italy, 19-20 September 2006; Washington, D.C., United States, 25-29 March 2007); and

(l) World Bank-UNCITRAL meeting on coordination in the area of secured financing law reform (Washington, United States, 27 March 2007).

IV. Dissemination of information

30. A number of publications and documents prepared by UNCITRAL serve as key resources for its technical cooperation and assistance activities, particularly with respect to dissemination of information on its work and texts. These resources are being developed to further improve the ease of dissemination of information and ensure that it is current and up to date. All recent publications are available both in hard copy and electronically.

A. Case Law on UNCITRAL Texts (CLOUT)

31. CLOUT, established for the collection and dissemination of case law on UNCITRAL texts, continues to be an important tool of the technical cooperation and assistance activities undertaken by UNCITRAL. The wide distribution of CLOUT in the six official languages of the United Nations promotes the uniform interpretation and application of UNCITRAL texts by facilitating access to decisions and awards from many jurisdictions.

32. The system is regularly updated with new abstracts, and the full text of the court decisions and arbitral awards are collected, but not published. As at the date of this note, 63 issues of CLOUT had been prepared for publication, dealing with 686 cases, relating mainly to the United Nations Convention on Contracts for the International Sale of Goods (CISG) and the UNCITRAL Model Law on International Commercial Arbitration.

33. The Digest of Case Law on the CISG, published in December 2004, has been reviewed in order to improve its uniformity in approach and style. The revised Digest will be presented to the CLOUT National Correspondents at their meeting on 5 July 2007.

34. A search engine to facilitate retrieval of published case law on the UNCITRAL website will be operative in the second half of 2007.

B. Website

35. The website, available in the six official languages of the United Nations, includes all UNCITRAL documents contained in the United Nations Official Documents System (ODS), as well as other information relating to the work of UNCITRAL. The website is maintained and developed at no additional cost to the Secretariat.

36. The number of visitors to the UNCITRAL website has increased by one quarter since the last report. About 45 per cent of the traffic is directed to pages in English, 30 per cent to pages in French and Spanish, and the remaining 25 per cent to pages in Arabic, Chinese and Russian.

37. The content of the website is updated and expanded on an on-going basis. In particular, UNCITRAL official documents relating to early Commission sessions are being uploaded in the ODS and made available on the website under a project on digitization of UNCITRAL archives conducted jointly with the Dag Hammarskjöld Library in New York.

C. Library

38. The UNCITRAL Law Library was established in 1979 in Vienna. Since its establishment, the Library has been providing services not only to UNCITRAL delegates and to the staff of the Secretariat, but also to the staff of permanent missions and the staff of other Vienna-based international organizations. It has also provided research assistance to scholars and students from many countries.

39. The collection of the UNCITRAL Law Library focuses mainly on international trade law and currently consists of over 10,000 monographs; 150 active journal titles; legal and general reference material, including non-UNCITRAL United Nations documents, and documents of other international organizations; and electronic resources (restricted to in-house use only). Lately, particular attention has been given to expanding the holdings in all of the six United Nations official languages.

40. The UNCITRAL Law Library maintains an online public access catalogue (OPAC) jointly with the other United Nations libraries in Vienna and with the technical support of the United Nations Library in Geneva. The OPAC is available via the library page of the UNCITRAL website and is located at the address <http://libunov-cat.unog.ch>.

D. Publications

41. UNCITRAL traditionally has two series of publications, in addition to official documents, which include the texts of all instruments developed by the Commission and the UNCITRAL Yearbook. A new book providing basic facts about UNCITRAL, "The UNCITRAL Guide", is in press.

42. Publications are regularly provided to support technical cooperation and assistance activities undertaken by the Secretariat, as well as by other organizations where the work of UNCITRAL will be discussed, and in the context of national law reform efforts.

E. Press releases

43. To improve the availability of up-to-date information on the status and development of UNCITRAL texts, efforts have been made to ensure that press releases are issued when treaty actions are taken or information is received on the adoption of a model law. Those press releases are provided to interested parties by email and are posted on the UNCITRAL website, as well as on the website of the United Nations Information Service (UNIS) in Vienna.

F. General enquiries

44. The Secretariat currently addresses approximately 1,750 general inquiries per year concerning, inter alia, technical aspects and availability of UNCITRAL texts, working papers, Commission documents and related matters. Increasingly, these inquiries can be answered by reference to the UNCITRAL website.

G. Information lectures in Vienna

45. On request, the Secretariat provides information lectures in-house on the work of UNCITRAL to visiting university students and academics, government officials and others. Since the last report lectures have been given to universities from Austria, USA, Finland, the Netherlands, Ukraine and Turkey.

V. Resources and funding

A. UNCITRAL Trust Fund for symposia

46. In the period under review, a contribution was received from Mexico, to whom the Commission may wish to express its appreciation.

47. The ability of the Secretariat to implement the technical cooperation and assistance component of the UNCITRAL work programme is contingent upon the availability of extrabudgetary funding, since the costs of technical cooperation and assistance activities are not covered by the regular budget.

48. The UNCITRAL Trust Fund for symposia supports technical cooperation and assistance activities for the members of the legal community in developing countries; participation of UNCITRAL staff, as speakers, at conferences where UNCITRAL texts are presented for examination and possible adoption; and fact finding missions for law reform assessments in order to review existing domestic legislation and assess country needs for law reform in the commercial field.

49. The Commission may wish to note that, in spite of efforts by the Secretariat to solicit new donations, funds remaining in the Trust Fund will be sufficient only for technical cooperation and assistance activities already planned for 2007. Beyond the end of 2007, requests for technical cooperation and assistance involving the expenditure of funds for travel or to meet other associated costs will have to be declined unless new donations to the Trust Fund are received or other alternative sources of funds can be found.

50. The Commission may once again wish to appeal to all States, relevant United Nations Agencies and bodies, international organizations and other interested entities to make contributions to the Trust Fund, if possible in the form of multi-year contributions, so as to facilitate planning and to enable the Secretariat to meet the increasing demands from developing countries and States with economies in transition.

B. UNCITRAL Trust Fund to grant travel assistance to developing countries that are members of UNCITRAL

51. The Commission may wish to recall that, in accordance with General Assembly resolution 48/32 of 9 December 1993, the Secretary-General was requested to establish a Trust Fund to grant travel assistance to developing countries that are members of UNCITRAL. The Trust Fund so established is open to voluntary financial contributions from States, intergovernmental organizations, regional economic integration organizations, national institutions and non-governmental organizations, as well as to natural and juridical persons. In the period under review, no contributions were received.

52. In order to ensure participation of all Member States in the sessions of UNCITRAL and its Working Groups, the Commission may wish to reiterate its appeal to relevant bodies in the United Nations system, organizations, institutions and individuals to make voluntary contributions to the Trust Fund established to provide travel assistance to developing countries that are members of the Commission.

53. It is recalled that in its resolution 51/161 of 16 December 1996, the General Assembly decided to include the Trust Funds for UNCITRAL symposia and travel assistance in the list of funds and programmes that are dealt with at the United Nations Pledging Conference for Development Activities.

IX. STATUS AND PROMOTION OF UNCITRAL LEGAL TEXTS

Status of conventions and model laws

(A/CN.9/626) [Original: English]

Not reproduced. The updated list may be obtained from the UNCITRAL secretariat or found on the Internet at *www.uncitral.org*.

X. COORDINATION AND COOPERATION

Note by the Secretariat on current activities of international organizations related to the harmonization and unification of international trade law

(A/CN.9/628 and Add.1) [Original: English]

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I. Introduction

1. In resolution 34/142 of 17 December 1979, the General Assembly requested the Secretary-General to place before the United Nations Commission on International Trade Law a report on the legal activities of international organizations in the field of international trade law, together with recommendations as to the steps to be taken by the Commission to fulfil its mandate of coordinating the activities of other organizations in the field.

2. In resolution 36/32 of 13 November 1981, the General Assembly endorsed various suggestions by the Commission to implement further its coordinating role in the field of international trade law.¹ Those suggestions included presenting, in addition to a general report of activities of international organizations, reports on specific areas of activity focusing on work already under way and areas where unification work was not under way but could appropriately be undertaken.²

3. This general report, prepared in response to resolution 34/142, is the third in a series which the Secretariat proposes to update and revise on an annual basis for the information of the Commission. The first paper (A/CN.9/584, May 2005) and related papers on electronic commerce (A/CN.9/579) and insolvency (A/CN.9/580/Add.1) were prepared for the thirty-eighth session of the Commission. The second paper (A/CN.9/598, April 2006) and related papers on procurement (A/CN.9/598/Add.1) and security interests (A/CN.9/598/Add.2) were prepared for the thirty-ninth session of the Commission. The present paper focuses on activities of international organizations primarily undertaken since preparation of the second paper. It is based upon publicly available material and consultations sought with the listed organizations. This paper does not repeat information contained in the previous papers unless necessary to facilitate understanding of a particular issue.

4. The work of the following organizations is described in this report:

(a) United Nations bodies and specialized agencies

ITU	International Telecommunications Union
UNECE	United Nations Economic Commission for Europe
UNESCAP	United Nations Economic and Social Commission for Asia and the Pacific
UNCTAD	United Nations Conference on Trade and Development
UNODC	United Nations Office on Drugs and Crime
WIPO	World Intellectual Property Organization

(b) Other intergovernmental organizations

ADB	Asian Development Bank
APEC	Asia Pacific Economic Cooperation Commonwealth Secretariat
EBRD	European Bank for Reconstruction and Development
EC	European Commission
Hague Conference	Hague Conference on Private International Law
OAS	Organization of American States

¹ *Official Records of the General Assembly, Thirty-sixth Session, Supplement No. 17 (A/36/17)*, paras. 93-101.

² *Ibid.*, para. 100.

OTIF	Intergovernmental Organization for International Carriage by Rail
OECD	Organization for Economic Cooperation and Development
Unidroit	International Institute for the Unification of Private Law
World Bank	International Bank for Reconstruction and Development
WCO	World Customs Organization
WTO	World Trade Organization
(c)	International non-governmental organizations
CTO	Commonwealth Telecommunications Organization
INSOL	International Association of Restructuring, Insolvency and Bankruptcy Professionals
IBA	International Bar Association
ICC	International Chamber of Commerce
III	International Insolvency Institute

II. Harmonization and unification of international trade law

A. International commercial contracts

Hague Conference³

5. The Hague Convention of 15 November 1965 on the Service Abroad of Judicial and Extrajudicial Documents in Civil or Commercial Matters (Hague Service Convention) provides for the channels of transmission to be used when a judicial or extrajudicial document is to be transmitted from one State Party to the Convention to another State Party for service in the latter. The Convention provides for one main channel of transmission (via a Central Authority of the requested State), and several alternative channels of transmission.

6. The Practical Handbook on the Operation of the Hague Service Convention was officially presented during the meeting of the Special Commission on General Affairs and Policy of the Hague Conference (3-5 April 2006). This fully revised and expanded edition of the Handbook offers detailed explanations on the general operation of the Convention as well as authoritative commentaries on the major issues raised by practice over the past forty years. The Handbook analyses or otherwise refers to approximately 250 court decisions rendered in a great number of jurisdictions in application of the Convention.

7. The Handbook also contains a FAQ section with succinct and practical replies that offer a quick overview of the Convention's main provisions and basic features.

³ www.hcch.net/.

This section is usefully complemented by four Explanatory Charts on various aspects of the Convention's operation. This paper edition of the Handbook comes with a fully searchable and easy-to-use e-book (in PDF format).⁴

8. At its meeting on 3-5 April 2006, the Special Commission on General Affairs and Policy of the Hague Conference invited the Permanent Bureau to prepare a feasibility study on the development of an instrument concerning choice of law in international contracts. In preparation of the study, which should consider in particular whether there is a practical need for the development of such an instrument, the Permanent Bureau has sent a Questionnaire to Member States, national and international arbitration institutions and — through the ICC secretariat — to the international business community. Moreover, a comparative law overview on the issue of choice of law in international contracts, both in court proceedings and arbitration, was drawn up.

Unidroit⁵

9. Pursuant to the recommendation of the Governing Council of Unidroit, the Principles of International Commercial Contracts (PICC), first published in 1994, are included as an on going project in the work programme of the Institute. Subsequent to the adoption of the second enlarged edition of the PICC in 2004, in 2005 the Governing Council decided to set up a new Working Group with the task of preparing a third edition of the PICC including new chapters on unwinding of failed contracts, plurality of obligors and of obligees, termination of long-term contracts for just cause. The Working Group, composed of eminent experts representing the major legal systems and/or regions of the world as well as observers from international organizations and arbitration centres, including UNCITRAL, held its first session in Rome from 29 May to 1 June 2006. On the basis of a preliminary study prepared by the Unidroit Secretariat, the Group proceeded to an in-depth discussion of the five topics suggested for inclusion in the new edition of the Principles and appointed several rapporteurs to deal with the topics of: unwinding of failed contracts; illegality; plurality of obligors and of obligees; conditions; and termination of long-term contracts for just cause. The Rapporteurs were invited to prepare position papers on their respective topics for discussion at the Group's next session in June 2007.

10. UNCITRAL, at its 40th session in July 2007, will be invited to give its endorsement to the 2004 version of the PICC.

B. International transport of goods

1. Transport by sea

UNCTAD⁶

11. UNCTAD continued its participation at sessions of the UNCITRAL Working Group III (Transport Law), submitting comments providing technical analysis on the issues under consideration and highlighting implications for developing

⁴ The Handbook is sold on a commercial basis by two distributors: Wilson & Lafleur (Montreal) and Bruylant (Brussels).

⁵ www.unidroit.org.

⁶ www.unctad.org.

countries, with respect to the development of a new international convention to govern the carriage of goods by sea as well as multimodal transport including a sea leg.

2. Transport by land

UNECE⁷

12. At the 99th session of the Working Party on Road Transport (SC.1) in October 2005, an editorial committee, comprising both Unidroit and UNCITRAL, was established to finalize the drafting of the text of an additional Protocol to the Convention on the Contract for the International Carriage of Goods by Road⁸ (Geneva, 19 May, 1956) (CMR) with a view to facilitating the possible use of electronic consignment notes. At its 100th session, two versions were considered, the first version prepared by Unidroit and amended to take account of comments by various delegations, and another prepared by the International Road Transport Union based largely on the ICAO Montreal Protocol. SC.1 opted for the first version and adopted the technical provisions of Protocol (ECE/TRANS/SC.1/379, Annex 3).⁹ Following comments by one delegation, the text was slightly amended with the consent of Unidroit, UNCITRAL and the International Road Transport Union (IRU). Regarding the final provisions of the Protocol, the Committee noted that, in the light of observations by the Treaty Section of the Office of Legal Affairs at United Nations Headquarters in New York, it was necessary to amend or supplement certain points, for example the introduction of a clause amending the Protocol. Since the secretariat cannot amend the text on its own authority without the prior agreement of members of SC.1, the Committee endorsed the secretariat's proposal to make written representations to the Contracting Parties to the CMR as soon as possible. The procedure for opening the Protocol for signature may be set in motion once there has been agreement by the Contracting Parties.

OTIF¹⁰

13. The Uniform Rules concerning the Contract for International Carriage of Goods by Rail, Appendix to the Convention concerning International Carriage by Rail (CIM-COTIF),¹¹ as amended by the Protocol of Modification of 1999 (Vilnius Protocol) entered into force on 1 July 2006.

3. Inland waterway transport

UNECE

14. The Budapest Convention on the Contract for the Carriage of Goods by Inland Waterway (CMNI Convention), adopted at a Diplomatic Conference organized jointly by CCNR, Danube Commission and UNECE (Budapest, 25 September-3 October 2000), entered into force on 1 April 2005. It currently has eight Contracting Parties: Bulgaria, Croatia, the Czech Republic, Hungary, Luxembourg, Netherlands, Romania and Switzerland. The CMNI Convention governs the

⁷ www.unece.org.

⁸ Entry into force: 2 July 1961, United Nations, *Treaty Series*, vol. 399, p. 189.
Source: www.untreaty.org.

⁹ For documentation see: www.unece.org/trans/main/sc1/sc1.html.

¹⁰ www.otif.org.

¹¹ Budapest, 22 June, 2001. Entered into force 1 April 2005.

contractual liability of parties to the contract for the carriage of goods by inland waterway and provides for the limitation of the carrier's liability.

4. Transport by air

UNCTAD

15. UNCTAD has prepared a guide on aspects of air law, designed to assist developing countries in their understanding of the complex international framework of air law conventions, including in respect of effective uniform implementation of conventions at the national level. The document, entitled "*Carriage of Goods by Air: A Guide to the International Legal Framework*" is available electronically at www.unctad.org/ttl/legal.

5. Intermodal transport

UNECE

16. At its forty-seventh session (Geneva, 5-6 March 2007), the Working Party on Intermodal Transport and Logistics was informed that the EC was preparing an action plan on logistics to be issued in November 2007. The action plan would address requirements for logistical infrastructures, including financing, urban freight transport, information technologies, dimensions of intermodal transport units (ITU), and working conditions in logistics. More detailed information on the action plan and the envisaged activities of the EC is to be made available at the October 2007 session of the Working Party.

17. The Working Party recalled in this context that, at its last session, it was considered premature to initiate work on a pan-European civil liability regime for transport covering road, rail, inland water and short sea shipping. The action plan prepared by the European Commission and the ensuing discussions possibly would provide additional elements to decide on this matter (ECE/TRANS/WP.24/113, paragraphs 17-21).¹²

C. Electronic commerce and new technologies

APEC¹³

18. Project outcomes for a project entitled, "Development of APEC Guidance for Electronic Commerce Using the Best Practices of E-Government Procurement Systems" were included in the final report presented to the Electronic Commerce Steering Group (ECSG) during a meeting held in Canberra, Australia in January 2007.¹⁴

19. Building on the first training course conducted in Beijing in October, 2006, APEC also conducted a second training program on e-trade and supply chain management aimed at reducing the digital divide between SMEs in developing economies and those in developed APEC economies by applying E-business and supply chain management. The second training course was held in Sanya, Hainan province, China on 27-30 March, 2007.

¹² www.unece.org/trans/wp24/wp24-reports/documents/113-e.pdf.

¹³ www.apec.org.

¹⁴ http://aimp.apec.org/Documents/2007/ECSG/ECSG1/07_ecsg1_010.doc.

20. Work continued on the implementation of APEC's Strategies and Actions Toward a Cross-Border Paperless Trading Environment to enable the electronic transmission of trade-related information across the region by 2020. Sixteen economies have prepared Paperless Trading Individual Action Plans. These plans outline the steps members should take to meet APEC's target to reduce or eliminate customs, cross-border trade administration and other documents relevant to international sea, air and land transport. The ECSG is also collaborating with the United Nation Centre for Trade Facilitation and Electronic Business to undertake work to enhance trade facilitation through technical cooperation and knowledge sharing, specifically in electronic standards for paperless trade.

EC¹⁵

21. In May 2007 political agreement on the implementation of pan-European electronic customs was reached by the European Council of Ministers. The electronic customs project initiated by the European Commission aims to replace paper format customs procedures with EU wide electronic ones in order to enhance security at the external borders of the European Union and to facilitate trade. The compromise agreement now needs to be confirmed by the European Parliament in a second reading which is expected to occur shortly.¹⁶

Hague Conference

22. During the Special Commission on General Affairs and Policy of the Hague Conference on Private International Law (HCCH) held in April 2006, the HCCH and the National Notary Association (NNA) officially launched the electronic Apostille Pilot Program (e-APP). Under this Program, the two Organizations are, together with any interested State, developing, promoting and assisting in the implementation of low-cost, operational and secure software models for (i) the issuance of and use of electronic Apostilles (e-Apostilles), and (ii) the operation of electronic Registers of Apostilles (e-Registers). The e-APP is designed to illustrate how the Conclusions and Recommendations of the 2003 Special Commission meeting on the practical operation of the Hague Apostille Convention and the 2005 International Forum on e-Notarization and e-Apostilles can be implemented in practice by relying on existing and widely used technology.

23. In February 2006 the state of Kansas issued the first test e-Apostille in accordance with the model suggested under the e-APP, and Colombia, the receiving State, officially indicated its acceptance of this test e-Apostille. As a result, the two jurisdictions are now ready to complete authentications of public documents entirely electronically. Furthermore, the state of Rhode Island joined the e-APP by adopting and implementing the Program's free, open-source electronic Register software. Any interested person can now conduct a secure, online search for an Apostille issued by Rhode Island officials (currently in paper form, soon also in electronic form) by entering its number and date and the register will show automatically if a matching entry can be found, thus allowing receiving parties to verify the origin of the Apostille much more quickly and efficiently than can be accomplished currently.

24. In the context of the development of a Convention on the international recovery of child support and other forms of family maintenance, the Hague

¹⁵ ec.europa.eu.

¹⁶ http://ec.europa.eu/taxation_customs/customs/policy_issues/electronic_customs_initiative/index_en.htm.

Conference on Private International Law, with the assistance of UNCITRAL, has been preparing proposals for medium-neutral and technology-neutral provisions to ensure that Central Authorities can employ the most rapid means of communication under the future instrument to transmit applications and relevant information and documents under the Convention to recover maintenance swiftly and at a low cost. The new Hague Convention takes account of future needs, the developments occurring in national and international systems of maintenance recovery and the opportunities provided by advances in information technology.

ITU¹⁷

25. In the framework of its “Countering Spam” activities, the International Telecommunication Union has created a platform to gather anti-spam legislation worldwide, and provide a list of the competent enforcement authorities and their contact details. Links to news and other sources is also provided. Information is regularly updated. Over 30 countries have provided information for the survey which is updated regularly.¹⁸

OECD¹⁹

26. On April 20, 2006, the OECD launched an anti-spam toolkit to help governments and industry work together to combat spam. The toolkit also includes an OECD recommendation on enforcement cooperation. The anti-spam toolkit, its annexes and background papers are available online.²⁰

27. As well, the OECD E-Government Project which was launched in 2001, explores how governments can best exploit information and communication technologies (ICTs) to embed good governance principles and achieve public policy goals. The Project produces reports on best practices and develops frameworks for addressing issues such as cost/benefit analysis, e-services and take-up. It also carries out country peer reviews on e-government. These reviews place e-government in a national context, and help identify the strengths and weaknesses of national e-government programmes. The OECD Network of Senior E-Government Officials met in Paris on 6-7 February 2006 to address issues regarding cost and benefit analysis of e-government.²¹

UNCTAD

28. The eventual adaptation of laws and regulations related to the use of ICT constitutes a key step towards the development of an information society in developing countries. In this sense, UNCTAD provides advisory services to developing countries on the legal aspects of e-commerce, and carries out related training and capacity-building. These activities enable legal professionals, policy makers, and private sector representatives to achieve a common understanding of e-commerce legal and regulatory issues for trade facilitation and harmonization of regional and national legal frameworks. Beneficiaries of capacity-building become more acquainted with key concepts such as intellectual property, content regulation, securing e-commerce, as well as with the United Nations Convention on the use of

¹⁷ www.itu.int.

¹⁸ www.itu.int/osg/spu/spam/law.html.

¹⁹ www.oecd.org.

²⁰ www.oecd-antispam.org.

²¹ Further information available at <http://webdomino1.oecd.org/COMNET/PUM/egovproweb.nsf>.

electronic communications in international contracts (2005). For example, UNCTAD training in the course of 2006 helped Cambodia and Lao PDR move forward in passing electronic commerce legislation before 2008 (the deadline specified by the e-ASEAN initiative) and customize such legislation to their own business environment. UNCTAD also helped the East-African Community (EAC) secretariat to formulate a roadmap for a harmonized framework for cyber laws in the region, and a series of actions was recommended as a follow-up to an UNCTAD workshop in December 2006. UNCTAD also trained African law-makers and government officials to understand the basic legal implications of e-commerce, and to identify the main policy issues involved, as well as the priority areas for law reform, improving their ability to draft e-commerce legislation. Finally, UNCTAD's Information Economy Report 2006 included a chapter on "Laws and Contracts in an E-commerce Environment" that examined the legal nature of communications and data messages in electronic commerce, including policy recommendations consisting of a checklist of issues for developing countries to consider when embarking on law reform designed to facilitate electronic commerce.²²

UNECE

29. The United Nations Centre for Trade Facilitation and Electronic Business (UN/CEFACT) has a global remit to develop a wide range of electronic business standards in support of trade and of government to business communications. Recent developments following the October 2006 UN/CEFACT Forum in New Delhi²³ and the March 2007 Forum in Dublin²⁴, include: publication of candidate release standards for the Cross Industry Invoice schema and eTendering schemas; approval of the United Nations Electronic Trade Documents (UNeDocs) Business Requirement Specification; and commencement of work on a new project on Cross Domain eProcurement.²⁵

30. The UN/CEFACT's new intellectual property rights (IPR) policy²⁶ was adopted at its annual plenary session in May of 2006.²⁷

31. Currently, UN/CEFACT is in the process of setting up a joint project with the World Customs Organization to develop an international Cross Border Reference Data Model (CBRDM). The CBRDM will allow better information exchange and coordination between Customs and other border agencies such as ministries of agriculture, health, finance and transport and will support the implementation of Single Windows for export and import.²⁸

32. UN/CEFACT's Legal Group has begun work on a Recommendation on the Legal Framework for Single Windows. This recommendation will seek to identify the legal issues involved in creating and operating a Single Window for international trade and suggest possible solutions. The Legal Group will soon circulate a draft version of this Recommendation for an internal review. The Legal Group is also working on a Unified Business Agreements and Contracts (UBAC) Project, which seeks to align the concepts defined within the ISO Open-EDI

²² Available at www.unctad.org/Templates/WebFlyer.asp?intItemID=3991&lang=1.

²³ (www.unece.org/cefact/prs/pr_india_oct06.doc).

²⁴ (www.unece.org/press/pr2007/07trade_p03e.htm).

²⁵ For more information refer to the following site: www.uncefactforum.org/.

²⁶ www.unece.org/cefact/cf_plenary/plenary06/trd_cf_06_11e.pdf.

²⁷ www.unece.org/cefact/cf_plenary/plenary06/list_doc_06.htm.

²⁸ See UN/CEFACT Recommendation 33 at www.unece.org/cefact/recommendations/rec_index.htm.

lifecycle stages of an e-business relationship with the legal processes of contract formation, performance and arbitration.

33. In addition, the Legal Group is focusing its attention on renewing and strengthening its working relationship with UNCITRAL. Representatives of the UNCITRAL secretariat and the Legal Group met in Vienna in 2006 to discuss common areas of work. As well Legal Group members participated in an UNCITRAL high-level Experts Group Meeting in February 2007 on the cross-border recognition of electronic signatures and authentication methods, where they made a presentation. The Legal Group will also present a paper focusing on the legal issues of the International Trade Single Window at UNCITRAL's Congress in July 2007.

UNESCAP²⁹

34. UNESCAP convened a conference from 27-29 November 2006 in Manila, the Philippines aimed at identifying the gaps between planning and implementing e-government in countries in the Asian and Pacific region, particularly in the areas of e-customs and e-procurement and to devise the ways for closing such gaps. The Conference was attended by fourteen participants from nine countries. It was organized as part of the activities of the ESCAP project entitled "Closing the gap between planning and implementation of e-government", which is funded by the Korea Information Society Development Institute (KISDI) and has been implemented by Information, Communication and Space Technology Division (ICSTD).

D. Commercial arbitration and conciliation

APEC

35. In 2006 APEC published the paper "The Role of ADR (Alternative Dispute Resolution) / ODR (Online Dispute Resolution) in Implementing the APEC Privacy Framework".³⁰ ADR/ODR was considered relevant to the work of APEC by: leveraging limited resources of enforcement; allowing companies to resolve disputes before "case filing"; and providing means of online resolution to consumers with recognized neutral third parties or transparent system while allowing for possible recourse to an arbitral authority.

CTO³¹

36. The CTO ADR Centre has established partnership relationships with the Chartered Institute of Arbitrators, the Centre for Effective Dispute Resolution and the Singapore Mediation Center. The CTO ADR Centre and the Claims Room.com Ltd jointly operate an online dispute resolution platform in partnership.³² Recognizing the need to build capacity within developing countries and in the industry sector itself the CTO ADR Centre conducts training programmes. One

²⁹ www.unescap.org.

³⁰ www.apec.org/apec/documents_reports/electronic_commerce_steering_group/2006_MedialibDownload.v1.html?url=/etc/medialib/apec_media_library/downloads/taskforce/ecsg/mtg/2006/pdf.Par.0091.File.v1.1.

³¹ www.cto.int/.

³² www.ctomediation.com/.

event has already been held in Cameroon and others are planned in Caribbean, Pacific and Asian regions.

ICC³³

37. The ICC Commission on Arbitration has constituted five task forces covering amiable composition and *ex aequo et bono*,³⁴ criminal law and arbitration, guidelines for ICC expertise proceedings, reducing time and costs in arbitration and trusts and arbitration.³⁵

38. The task force on amiable composition and *ex aequo et bono*³⁶ was mandated to identify the essential features of “amiable composition” and of “*ex aequo et bono*” and study the role of the arbitrators when acting as “amiable compositeurs” or when deciding “*ex aequo et bono*” (e.g. jurisdictional, procedural or substantive problems that may arise). The task force met on 22 May 2006, to analyse answers to the first task force survey and is currently preparing a report based on a synthesis of the survey answers. It will also begin drafting guidelines to assist arbitrators who have been empowered to decide “*ex aequo et bono*” or to act as “amiable compositeurs”.

39. The task force on criminal law and arbitration³⁷ was mandated to study the impact of criminal law in the framework of arbitrations (e.g. jurisdictional, procedural and substantive problems that may arise) and also study the role of arbitral tribunals when facing situations in which problems related to criminal law arise. The task force has, by circulating a questionnaire, obtained information on the topic from ICC arbitrators, National Committees and Members of the Task Force and compiled the information into a synopsis, which covers various legal traditions. It has decided to limit its study and final report to the arbitrators’ duty to report a criminal offence; the arbitrators’ duty to appear as a witness if summoned by the authorities; the arbitrators’ ability to invoke professional privilege to the questions that he/she is asked; and the definition of professional privilege.

40. Following the adoption by the ICC Commission in Arbitration of the revised ICC Rules for Expertise in 2003, another task force prepared a set of guidelines for ICC expertise proceedings.³⁸ The task force is now preparing explanatory notes for the use of experts covering issues including: the use of experts in ICC Arbitration; using experts under the ICC Rules for Expertise as fact finders; and neutral experts as facilitators under the ICC ADR and Dispute Board Rules.

41. A task force on reducing time and costs in international arbitration³⁹ is currently preparing a synthesis of a survey circulated on that topic and will analyse

³³ www.iccwbo.org/.

³⁴ www.iccwbo.org/policy/arbitration/id6566/index.html.

³⁵ This Task Force has the following mission: to study and identify specific issues related to “Trusts and Arbitration” and, if deemed appropriate, prepare a report with respect thereto; to study the possibility of suggesting a draft ICC model arbitration clause to be included in the trust deed, and, if deemed appropriate, to propose such a clause and to prepare an explanatory note with respect thereto. The Task Force met on 5 February 2007 at the ICC Headquarters to start working on the adaptation of a model arbitration clause to the particularities of Trusts.

³⁶ Further information is available at www.iccwbo.org/policy/arbitration/id6566/index.html.

³⁷ Further information is available at: www.iccwbo.org/policy/arbitration/id1783/index.html.

³⁸ Information on the task force on guidelines for ICC expertise proceedings is available at www.iccwbo.org/policy/arbitration/id1785/index.html.

³⁹ www.iccwbo.org/policy/arbitration/id3874/index.html.

the problems raised therein grouped into parties' responsibilities, arbitral tribunal responsibilities and institution responsibilities.

OECD

42. In a report adopted on 30 January 2007 by the OECD Committee on Fiscal Affairs entitled "Improving the Resolution of Tax Treaty Disputes",⁴⁰ the OECD has agreed to modify the OECD Model Tax Convention, which serves as a basis for most negotiations between countries on tax matters, by including the possibility of arbitration in cross-border disputes over taxation if they remain unresolved for more than two years.

43. The decision was based on the recognition that with the growth of cross-border trade and investment and the accompanying increase in the number of people working abroad, cross-border tax disputes arising when two states assert conflicting rights to tax an individual living and working in more than one country or companies that invest outside their home country, have also increased.

44. The report addresses a number of issues relating to what is known as the "mutual agreement procedure", or MAP, the mechanism provided by tax treaties to resolve disputes between the countries that sign these treaties. At the same time, the Committee has published a web-based manual setting forth 25 best practices to help countries to improve the existing mechanisms for resolving tax disputes.⁴¹

UNCTAD

45. UNCTAD has developed and is implementing a project on "Building capacity through training in dispute settlement in International Trade, Investment and Intellectual Property". The objective of the project is to promote the integration of developing countries and countries in transition into the multilateral trading system through capacity-building on dispute settlement in International Trade, Investment and Intellectual Property. It aims to achieve this by improving the knowledge and level of critical awareness of the legal framework governing dispute settlement in international economic and trade relations.

46. The project focuses on the dispute settlement rules and mechanisms of international organizations such as ICC, ICSID, UNCITRAL, WIPO and WTO under five headings: (1) General Dispute Settlement Topics; (2) Settlement of International Investment Disputes and ICSID; (3) Settlement of International Trade Law Disputes and WTO; (4) Settlement of International Intellectual Property Disputes and WIPO; (5) International Commercial Arbitration; and (6) Regional Approaches. The comprehensive course on dispute settlement consists of forty chapters or modules, each dealing with one specialized topic as an essential building block of international dispute settlement.⁴² The pedagogical methodology, on which

⁴⁰ www.oecd.org/dataoecd/17/59/38055311.pdf.

⁴¹ www.oecd.org/document/26/0,2340,en_2649_37427_36197402_1_1_1_37427,00.html.

⁴² General topics: International Court of Justice; Permanent Court of Arbitration. Investment disputes: Overview; Selecting the Appropriate Forum; Consent to Arbitration; Requirements Ratione Personae; Requirements Ratione Materiae; Applicable Law; Procedural Issues; Post-Award Remedies; Binding Force and Enforcement; Trade Disputes: Overview; Panels; Appellate Review; Implementation and Enforcement; GATT 1994; Anti-dumping Measures; Subsidies and Countervailing Measures; Safeguard Measures; Sanitary and Phytosanitary Measures; Technical Barriers to Trade; Textiles and Clothing; Government Procurement; GATS; TRIPS; Agriculture. Intellectual property: (WIPO) Arbitration and Mediation Centre;

the format of the modules is based, allows for self-study for beginners and includes a tool to test what has been learned. At the same, the modules provide a quick introduction to specialists, who find guidance to further specialized sources and materials. The course was developed in English, with partial translation in Spanish and French and Portuguese. Over one million copies of the modules have been downloaded to date (February 2007).

47. Capacity-building workshops are being held to train officials, academics, legal practitioners and business from developing countries, including LDCs, and countries in transition.

48. Since its start in May 2002, the project has successfully cooperated with United Nations bodies and international organizations, such as the World Trade Organization (WTO), the World Intellectual Property Organization (WIPO), the International Chamber of Commerce (ICC), the International Centre for Settlement of Investment Disputes (ICSID) of the World Bank Group, the United Nations Commission on International Trade Law (UNCITRAL), the World Bank, and the Advisory Centre on WTO Law. There is also cooperation with national and regional institutions, especially in the organization and delivery of workshops.

WIPO⁴³

49. WIPO has released a number of publications providing an overview of the resources and services offered by the WIPO Mediation and Arbitration Center ('the Center') and encouraging parties to seek alternative dispute resolution mechanisms. These publications include: WIPO Services under the UNCITRAL Arbitration Rules, WIPO Arbitration and Mediation Rules, Dispute Resolution for the 21st century, Guide to WIPO Arbitration, Guide to WIPO Domain Name Dispute Resolution and the Guide to WIPO Mediation.

LCIA⁴⁴

50. On 5 May 2006, a joint meeting of the LCIA Court and Board voted to publish the LCIA Court's decisions on challenges to arbitrators. The Court based its decision on a report that studied the LCIA challenge decisions since 1995. The report also reviewed the practice and procedure in dealing with conflicts and challenges in other institutions such as the ICC and the AAA. The Court decided that publication will be in the form of abstracts and that all of its decisions will be published. Work is now under way to prepare an introductory text and the abstracts, for review by the full LCIA Court, which will then decide whether the abstracts should be published on the LCIA website, or in paper form, or both.

Internet Domain Name Dispute Resolution. International Arbitration: Overview; Submission Agreement/Clause; Arbitral Tribunal; Arbitral Proceedings; Applicable Law; Making the Award; Recognition and Enforcement of the Award; Court Measures; Electronic Arbitration; Regional mechanisms: NAFTA; MERCOSUR; ASEAN.

⁴³ www.wipo.int.

⁴⁴ www.lcia-arbitration.com.

E. International payments

Hague Conference

51. In the context of the development of a convention on the international recovery of child support and other forms of family maintenance, the Hague Conference on Private International Law, hopes that UNCITRAL could undertake work in relation to financial mechanisms of protection against foreign exchange fluctuations. Such mechanisms as used everyday for commercial transactions could be beneficial to the international recovery of child support by providing mechanisms to reduce arrears build-up over time caused by foreign exchange fluctuations.

ICC

52. The 2007 Revision of Uniform Customs and Practice for Documentary Credits, UCP 600, (ICC Publication No. 600) were approved by the ICC Commission on Banking Technique and Practice⁴⁵ on 25 October 2006. The UCP were first published by ICC in 1933. Revised versions were issued by the ICC in 1951, 1962, 1974, 1983 and 1993. Written into virtually every letter of credit, the UCP are accepted worldwide. UCP 600 is expected to be implemented from 1 July 2007 and contains significant changes to the existing rules, including: a reduction in the number of articles from 49 to 39; new articles on “Definitions” and “Interpretations” providing more clarity and precision in the rules; a definitive description of negotiation as “purchase” of drafts of documents; the replacement of the phrase “reasonable time” for acceptance or refusal of documents by a maximum period of five banking days. UCP 600 also includes the 12 Articles of the eUCP, ICC’s supplement to the UCP governing presentation of documents in electronic or part-electronic form.

F. Competition law

UNCTAD

53. As a follow up to the Fifth Review Conference, the eighth session of the Intergovernmental Group of Experts (IGE) on Competition Law and Policy was held in Geneva from 31 October until 2 November 2006 and considered four specific competition policy issues for better implementation of the “Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices” (the Set), adopted by the General Assembly in 2005, as they relate to: (i) interface between competition and sectoral regulators; (ii) hard-core cartels; (iii) cooperation and dispute settlement mechanisms; and (iv) subsidies. In addition, the IGE also organized a voluntary Peer review of the competition policy and law of Tunisia. Over the period under review, UNCTAD continued to assist interested member states in adopting and implementing competition law and policy in line with the principles and rules multilaterally agreed in the UN Set of Principles on Competition Policy.

⁴⁵ For more information, see www.iccwbo.org/home/banking/commission.asp.

G. Trade facilitation

UNCTAD

Harmonizing organic agricultural standards at regional level

54. Laws and regulations dealing with technical standards are an important determinant of trade flows at regional and multilateral level. Harmonization of such trade-related technical standards would therefore provide additional export opportunities for developing country producers. One such harmonization initiative carried out by UNCTAD in 2006 was the promotion of a common East African Organic Standard. The EAOS will become the second regional organic standard in the world after the European Union's and the first ever to have been developed in cooperation between the organic movements and the National Standards Bodies. The EAOS is expected to boost organic trade and market development in the region, raise awareness about organic agriculture among farmers and consumers, and create a unified negotiating position that should help East African organic farmers win access to export markets and influence international organic standard setting processes.⁴⁶

H. Insolvency

EBRD

55. Recognizing that a solid law is not enough for an effective insolvency system, the EBRD has endeavoured to build on its core principles for an insolvency law regime and focus on the effectiveness of insolvency system by identifying a set of principles to guide countries in setting standards for the qualifications, appointment conduct, supervision, and regulation of office holders ("Office holders" are the trustees, administrators, liquidators, insolvency representatives, or similar functionaries who make many insolvency systems work) in insolvency cases. The draft EBRD Insolvency Office Holder Principles are available on the EBRD's website.⁴⁷

International Insolvency Institute (III)/American Law Institute (ALI)

56. As noted in the previous report, the III and the ALI have embarked upon a joint project to develop a statement of "Principles of Cooperation in International Insolvency Cases". A first meeting was held in June 2006 and a second meeting is planned for June 2007. Approval of the Principles will be sought from professional and judicial associations.

INSOL

57. As foreshadowed in the previous report, in 2006 INSOL published:

(a) "Financing in Insolvency Proceedings", covering the different insolvency procedures that are available, the extent to which lenders get involved in providing finance to insolvent companies and related issues such as getting security, priority given to new lenders, and the role of the judicial process in 12 countries; and

⁴⁶ For more information see www.unctad.org/Templates/Page.asp?intItemID=4070&lang=1.

⁴⁷ See www.ebrd.org/country/sector/law/insolve/Princip/principles.pdf.

(b) “Credit Derivatives in Restructurings”, a guidance booklet for insolvency practitioners and others on matters relating to the impact of credit derivatives in restructurings. The book covers an overview of the credit derivatives market, basic elements of credit default swaps, settlement following a credit event, and a comparison with other types of credit products and techniques.

58. A further publication on treatment of secured claims in insolvency as well as pre-insolvency proceedings, as well as the second in a series of technical papers, entitled “Formalities for the transfer of businesses in insolvency” will be published in 2007.

59. In 2006, INSOL International and the American Bankruptcy Institute launched GLOBAL INSOLvency to provide a comprehensive source of information both on current issues in international insolvency and restructuring law and on the legal framework for insolvency and restructuring around the world.

OECD

60. The fifth meeting of the Forum on Asian Insolvency Reform (FAIR), organized by OECD in cooperation with APEC, the Australian Agency for International Development (AusAID), the Asian Development Bank, the World Bank and the Government of Japan, took place in Beijing, PRC from 27 to 28 April 2006. Participants examined the lessons from ten years of institutional and legal reforms of Asian insolvency systems and discussed the relevance of international guidance to improving insolvency systems, focussing in particular on the UNCITRAL Legislative Guide on Insolvency, the World Bank Principles on Insolvency and Creditor Right Systems and the UNCITRAL Model Law on Cross-Border Insolvency.

61. The inaugural conference on corporate governance hosted by the Hawkamah Institute for Corporate Governance and the OECD for countries the Middle East and North Africa (MENA) adopted the Dubai Declaration on Corporate Governance, which includes agreement that MENA countries should act to establish effective insolvency systems and provide a framework for value maximization and more efficient allocation of capital to productive uses. It has been agreed that a module on corporate restructuring and insolvency should be included in the work programme and will involve establishing partnerships with interested organizations, including in the private sector.

World Bank

62. In June 2006, The World Bank organized the 2006 Working Group Session of the Global Judges Forum, in cooperation with the International Association of Judges, the Latin American Federation of the Judiciary, the European Association of Judges, the Argentine Federation of Magistrates, and the Argentine Association of Federal Judges in Buenos Aires. Topics included: mediation and arbitration in commercial/insolvency cases, streamlining commercial proceedings using non-judicial entities and processes; delegation/substitution in enforcement proceedings and judicial cooperation and court-to-court-communication in cross-border insolvency proceedings

63. In 2007, the World Bank joined UNCITRAL and INSOL to co-sponsor the seventh in the series of multinational judicial colloquium focussing on coordination and cooperation in cross-border insolvency organized by UNCITRAL and INSOL since 1995.

A/CN.9/628/Add.1 [Original: English]**Current activities of international organizations related to the harmonization and unification of international trade law****ADDENDUM****CONTENTS**

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I. Corporate governance**EBRD¹**

1. In 2006, EBRD published the Transition Report 2006, devoted to an analysis of the financial sector in transition countries. The Report looked at how financial systems have been restructured over the past 15 years, their impact on the economy and private sector development and the introduction of new financial services.² As well, the EBRD published, “Law in transition online 2006 — Focus on central Europe”.³ This edition of the Bank’s legal journal, Law in transition online, charts and evaluates eight countries’ remarkable progress since their accession to the European Union and critically assesses the challenges they now face as part of an enlarged EU.

OECD

2. From 29-30 March 2007 in Shanghai, China, the OECD and the Shanghai Stock Exchange in partnership with the Japanese Government, the Global Corporate Governance Forum (GCGF) and the Yale School of Management convened a high level meeting to exchange experience on corporate governance.⁴

3. The OECD also recently published a report entitled “Intellectual Assets and Value Creation: Implications for Corporate Reporting”⁵ which found that companies can boost their stock market valuations and lower their cost of capital through

¹ www.ebrd.com/.

² For more information, see www.ebrd.com/pubs/econo/6813.htm.

³ For more information, see www.ebrd.com/pubs/legal/lit062.htm.

⁴ For more information, see

www.oecd.org/document/61/0,2340,en_2649_37439_34970813_1_1_1_37439,00.html.

⁵ www.oecd.org/dataoecd/2/40/37811196.pdf.

improved reporting of intellectual assets and value creation strategies that overcome the limits of accounting standards.

J. Procurement

WTO

4. The WTO working party on GATS rules is continuing negotiations on government procurement in services under GATS article XIII. Discussions in 2006 evolved around communications from the European Communities (S/WPGR/W/52 and S/WPGR/W/54), which touched upon such issues as technical specification, qualification of suppliers, procurement methods, time periods, tender documentation, and contract award (S/WPGR/W/52), and proposed a legal text for an annex to the GATS on government procurement (S/WPGR/W/54). Other questions raised included the relationship to the plurilateral WTO Government Procurement Agreement (the “GPA”).⁶

5. Within the WTO Committee on Government Procurement that administers the GPA (“the Committee”), the negotiations that focused on the simplification and improvement of the non market access related provisions of the GPA resulted in an understanding on the revision of the 1994 text.⁷ Apart from editorial changes to the 1994 text, including relocation of a number of provisions, significant substantive revisions have been made, including to the provisions addressing the needs of developing countries, the content of notices of intended procurement and tender documentation, qualification of suppliers, and modifications and rectifications to coverage.⁸ New articles have been introduced,⁹ and the text has been amended to accommodate and regulate the use of electronic means of communication and techniques.¹⁰

6. According to article XXII (Final provisions) of the revised text of the GPA, negotiations are expected to continue on some revised provisions, including on the rules of origin in the light of the outcome of the ongoing work in the WTO in that area. It is also envisaged that, not later than the end of the third year from the date of entry into force of the revised GPA, the Committee will undertake further work to

⁶ See “Annual report of the Working Party on GATS rules to the Council for Trade in Services”, 2006, document S/WPGR/16, 23 November 2006, paras. 5 and 6, available, as of 26 February 2007, at www.wto.org/english/tratop_e/gproc_e/gpserv_e.htm.

⁷ The revised text of the GPA has been circulated among all WTO members as document GPA/W/297. The footnotes in the revised text mark provisions that are still under negotiation. The revised text of the GPA is intended for use as basis for consultations and other ongoing work relating to the accession of new parties. See also “Report of the Committee on Government Procurement (November 2005-December 2006)”, document GPA/89, 11 December 2006, paras. 18-21. The report and the revised text of the GPA are available, as of 26 February 2007, at www.wto.org/english/tratop_e/gproc_e/gp_gpa_e.htm.

⁸ See articles IV, VII, X, IX and XIX of the revised text.

⁹ On definitions (article I), general principles (article V that consolidates some of the provisions of the 1994 text, such as on national treatment and non-discrimination, rules of origin and offsets, and adds new provisions, such as on use of electronic means and conduct of procurement), conditions for participation (article VIII), electronic reverse auctions (article XIV), transparency of procurement information and disclosure of information (articles XVI and XVII, which are based on the provisions of articles XVIII and XIX of the 1994 text), and modifications and rectifications to coverage (article XIX).

¹⁰ See, for instance, articles I, II, V-VII, IX- XI and XVI of the revised text.

consider the advantages and disadvantages of developing common nomenclature for goods and services and standardized notices. Within the Committee, agreement was also reached on arrangements for conclusion of the market access aspect of the negotiations under Article XXIV:7 of the 1994 GPA. The overall goal was to complete the market access negotiations (and therefore all aspects of the negotiations) in spring 2007.¹¹

Multilateral development banks (MDBs)

Joint working group on Harmonization of Electronic Government Procurement

7. During the period under review, the MDBs' joint Working Group on Harmonization of Electronic Government Procurement (e-GP) (the "joint Working Group"),¹² has been revising its E-Tendering Requirements and the E-reverse Auction Guidelines,¹³ to reflect experience with their implementation in practice. Revisions intend to address, in particular, criteria for charging fees for the use of electronic procurement systems, conditions for the use of exclusively electronic or paper system in procurement proceedings or allowing both, and encryption requirements in technology neutral terms and provide for more flexible regulation of electronic reverse auctions.

8. The joint Working Group has also sponsored (i) the preparation of new guidelines and papers, such as a note on electronic purchasing and a working paper on corruption in the context of the use of new technologies in public procurement, (ii) the development of interactive standard bidding documents for IT products, expected to be piloted in May 2007, (iii) an online e-GP training tool, expected to be operative in July 2007, (iv) international e-GP survey, expected to be published by June 2007, that covers e-GP systems from a total of fifteen countries and intends to identify the strategic approaches of the surveyed countries to e-GP programs, including system functionalities, issues that they faced in the transition to e-GP, costs and benefits, success factors, and lessons learned, and (v) an international e-GP conference, to be held in Washington D.C. in November 2007.

Revisions of MDBs' policies

9. In October 2006, the World Bank revised its Procurement and Consultant Guidelines and updated standard bidding and consulting documents¹⁴ and it published the Consulting Services Manual.¹⁵ It is in the process of updating a manual on procurement of goods or works, to reflect recent policy changes. The ADB issued new Procurement Guidelines in April 2006 and, effective 8 September 2006, revised definitions therein of corrupt, fraudulent, coercive and collusive

¹¹ See supra, endnote 6, "Report of the Committee on Government Procurement (November 2005-December 2006)", document GPA/89, 11 December 2006, paras. 22-23.

¹² The Working Group was set up at the beginning of 2003 by the ADB, the IADB, and the World Bank, and subsequently joined by the AfDB, EBRD and Nordic Development Fund. The UNCITRAL secretariat has participated as observer in the Working Group's meetings since 2005.

¹³ Available at the joint e-GP portal www.mdb-egp.org/.

¹⁴ The revised versions (as of 1 October 2006) are available at the World Bank web site.

¹⁵ Available as of 9 February 2007 at <http://siteresources.worldbank.org/INTPROCUREMENT/Resources/2006ConsultantManual.pdf>.

practices.¹⁶ The AfDB reported that its revised procurement policies were due for approval in 2007.

10. In August 2006, a new set of standard documents was prepared within the auspices of the regular meetings of the Heads of Procurement for the MDBs and International Financial Institutions for adoption and use by their respective institutions. The Standard Prequalification Document and user's guide are intended primarily for use in prequalifying applicants who express an interest in bidding on large building and civil engineering contracts under international competitive bidding procedures. The principles may also be applied if prequalification is needed under national competitive bidding.¹⁷

APEC

11. In September 2006, the APEC Committee on Trade and Investment endorsed the revised non-binding Principles on Government Procurement (the "NBPs").^{18, 19} The revised text builds on the 1999 version of the NBPs. Apart from structural and editorial changes,²⁰ substantive amendments have been made to the 1999 text. The revised NBPs strengthen some elements of the principles, especially in the cross-border context, and address some issues arising from the use of modern means of communication in public procurement. Unlike the 1999 version, the revised NBPs do not contain provisions related to suppliers' registers and to charging fees in the context of access to procurement-related information. In addition, the transparency principle included in the 1999 version has been subsumed into the area-specific APEC Transparency Standards on Government Procurement,²¹ which are included in the revised NBPs by cross-reference.²²

EC

Revision of the remedies directives

12. In May 2006, the European Commission put forward a proposal for a directive seeking to amend the two European Union remedies directives in the area of public procurement.²³ The proposal intends to clarify and improve the effectiveness of the

¹⁶ Both the new Guidelines and amendments thereto are available as of 8 February 2007 at <http://adb.org/Documents/Guidelines/Procurement/>.

¹⁷ Available at the World Bank website.

¹⁸ See the summary of the third meeting for 2006 (Da Nang, Viet Nam, 12-13 September 2006), paragraph 56, available as of 8 February 2007 at www.apec.org/content/apec/documents_reports/committee_trade_investment/2006.html.

¹⁹ The revised September 2006 version of the NBPs can be found in document 2006/SOM3/GPEG/005, "Review of the APEC Non-Binding Principles (NBPs) on Government Procurement", available as of 13 February 2007 at http://aimp.apec.org/Documents/2006/GPEG/GPEG2/06_gpeg2_005.pdf.

²⁰ As regards the structural changes, the revised text sets out the main elements of each principle and requirements under it upfront in the text, with more detailed commentary to each principle in annexes. This structure is different from the one followed in the 1999 version.

²¹ APEC Leaders' Transparency Standards, Santiago, Chile – 21 November 2004, document number 028.

²² See annex 6 in document 2006/SOM3/GPEG/005, *supra*, endnote 14.

²³ Document COM(2006) 195 final/2, 2006/0066 (COD), of 14 June 2006. The directives in question are (i) Directive 89/665/EEC that applies, in principle, to contracts for works, services and supplies awarded by contracting authorities, now coming under Directive 2004/18/EC; and (ii) Directive 92/13/EEC that applies to contracts awarded by contracting entities operating in

current review provisions in the formal award procedures or in the case of illegal direct awards of contracts. It introduces, among other amendments, a “standstill period”, during which awarding authorities would be obliged to suspend the conclusion of a public contract, in order to allow bidders to bring review procedures, and specifies the details of the standstill obligation, such as its scope, consequences and enforcement, the time span and permissible exceptions.

Procurement of defence contracts

13. At the end of 2006, the European Commission adopted an “Interpretative Communication on the application of article 296 of the Treaty in the field of defence procurement”.²⁴ The communication is a non-legislative measure and does not modify but clarifies the existing legal framework. It aims to prevent possible misinterpretation and misuse of article 296 of the Treaty of Rome establishing the European Community (the “Treaty”), which gives the States members of the European Community the possibility of derogating from the Community public procurement rules when this is necessary for protection of their “essential security interests”.²⁵ The communication explains the principles of the exemption, and clarifies the conditions for its use in the light of the case law of the European Court of Justice (the “ECJ”).

14. In parallel, the European Commission has carried out an impact assessment in order to determine whether a possible directive on the procurement of defence equipment would be useful, by introducing more flexible rules, which are better suited to the specific nature of defence markets, than those contained in the current public procurement directive 2004/18/EC. The European Commission’s Legislative and Work Programme 2007 (the “2007 Work Programme”)²⁶ envisages elaboration by the European Commission of a proposal for a directive on the coordination of procedures for award of public contracts in the defence sector as well as other legislative and non-legislative actions in the area of defence sector procurement.²⁷

the water, energy, transport and postal services sectors, now coming under Directive 2004/17/EC.

²⁴ Document COM (2006) 779 final, of 7 December 2006. The preparation of the interpretative communication was preceded by the assessment of the defence procurement market (see Commission Staff Working Document SEC (2006) 1554 of 7 December 2006). Its findings have indicated that the defence sector has been kept out of the application of the public procurement directive 2004/18/EC by virtue of the extensive use by the EU member States of the exemption provided by article 296 with the result that a majority of defence contracts have been awarded on the basis of national procurement rules, which differ widely throughout the EU. It was observed that this could limit market access for non-national suppliers, creating extra costs and inefficiencies that had a negative impact on the competitiveness of Europe’s defence industry. See IP/06/1703 of 7 December 2006.

²⁵ See also article 10 of the European Union public procurement directive 2004/18/EC, according to which, the directive applies to “contracts awarded by contracting authorities in the field of defence, subject to Article 296 of the Treaty”.

²⁶ Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions, Brussels, 24 October 2006, document COM(2006) 629 final; available, as of 26 February 2007, at http://eur-lex.europa.eu/LexUriServ/site/en/com/2006/com2006_0629en01.pdf.

²⁷ Such as a communication on defence industries and markets, and a proposal for a regulation on the transfer of defence products.

Award of low-value contracts

15. In July 2006, the European Commission published²⁸ an interpretative communication on the Community law applicable to contract awards not, or not fully, subject to the provisions of the public procurement directives.²⁹ The communication explains and clarifies how the principles of EU law should be applied to two types of contracts: (i) low-value contracts to which the directives do not apply as their contract values are below the thresholds for application of these directives, but which nevertheless may have cross-border interest; and (ii) service contracts (so called Annex B services) that, although covered by the directives, are subject to only a limited number of rules. The communication does not create any new legislative rules but provides the European Commission's understanding of the existing ECJ case law applicable to these types of contracts and suggests best practices to assist member States to comply with the internal market requirements confirmed by the ECJ case law.³⁰

Public Private Partnerships (PPPs)

16. On 26 October 2006, the European Parliament adopted a resolution on public-private partnerships and Community law on public contracts and concessions (2006/2043(INI)).³¹ In its resolution, the Parliament confirmed application of the Community public procurement law to PPPs, including institutionalised public-private partnerships ("IPPPs") (paragraphs 2, 6, 7 and 37). The Parliament considered that it was premature to assess the effects of the public procurement directives and therefore opposed a review of these directives (paragraph 2). It also opposed the establishment of a European agency for PPPs (paragraph 18).

17. The Parliament requested the European Commission to undertake a number of actions under the resolution, such as to make recommendations as to an appropriate procurement procedure in the field of concessions (paragraph 32) and to provide clarifications about the application of procurement law to the creation of public-private undertakings in connection with the award of a contract or concession (paragraph 35).³² It supported the European Commission in its efforts to ascertain whether standard procurement rules should be created for all PPPs on a contractual basis, irrespective of whether the PPPs concerned qualify as a public contract or a concession, and to take action in the field of IPPPs in view of the clear signs of existing legal uncertainty (paragraphs 33 and 34).

18. The 2007 Work Programme, acknowledging the demand for a stable, consistent legal environment for the award of concessions at the European Union level, envisages the European Commission's action in the form of drafting a

²⁸ Document 2006/C 179/02.

²⁹ The directives in question are the European Union (EU) procurement directives 2004/17/EC and 2004/18/EC.

³⁰ In addition on the same subject, the European Parliament, in its resolution 2006/2043(INI) of 26 October 2006, opposed the creation of rules on the award of public procurement contracts beneath the threshold values at the EU level, underlining the responsibility of the Member States to implement in an efficient way the Treaty principles of transparency, non-discrimination and the freedom to provide services in relation to public procurement contracts beneath the threshold values (paragraph 21 of the resolution).

³¹ As of 26 February 2007, available at http://ec.europa.eu/internal_market/publicprocurement/ppp_en.htm#conclusions.

³² See also paragraphs 38 and 43 of the resolution.

proposal for a directive on the coordination of procedures for the award of concessions.³³

Other procurement-related initiatives under the 2007 European Commission's Legislative and Work Programme

19. The 2007 Work Programme envisages actions in the field of green public procurement. They include: (i) submission of proposals for EU-wide green public procurement target and for regular benchmarking and monitoring by the European Commission and the member States; (ii) giving guidance to member States for the adoption of national action plans on green public procurement; and (iii) revisions to regulations (EC) No 1980/2000 on a revised Community eco-label award scheme and (EC) 761/2001 allowing voluntary participation by organizations in a Community eco-management and audit scheme (EMAS), with a view, inter alia, of creating the links with the EU green public procurement instruments.³⁴

20. The 2007 Work Programme also envisages revision of regulation (EC) No. 2195/2002 on the Common Procurement Vocabulary (CPV), necessary to maintain an efficient and simple procurement system that is easily applied for both suppliers and bidders.³⁵

United Nations Office on Drugs and Crime³⁶: United Nations Convention against Corruption³⁷

21. The first Conference of States Parties to the United Nations Convention against Corruption was held in December 2006.³⁸ Around the same time, the Conference secretariat — the United Nations Office on Drugs and Crime (“UNODC”) published the Legislative Guide for the Implementation of the United Nations Convention against Corruption.³⁹ The objective of the Guide is to assist States seeking to ratify and implement the Convention by identifying legislative requirements, issues arising from those requirements and various options available to States as they develop and draft the necessary legislation.⁴⁰ Some paragraphs of the Guide relate to the provisions of the Convention dealing with public procurement⁴¹ and management of conflict of interest in public administration.⁴²

OECD

OECD DAC Joint Venture on Procurement

22. On 17 July 2006, the OECD DAC Joint Venture on Procurement, set up to oversee the implementation of the Paris Declaration on Aid Effectiveness of

³³ See supra, endnote 25.

³⁴ Ibid.

³⁵ Ibid.

³⁶ www.unodc.org.

³⁷ General Assembly resolution 58/4, annex.

³⁸ Documents of the Conference are available as of 8 February 2007 at www.unodc.org/unodc/caccosp_2006.html.

³⁹ United Nations publication, Sales No E.06.IV.16. Available in electronic format, as of 8 February 2007, at www.unodc.org/pdf/corruption/CoC_LegislativeGuide.pdf.

⁴⁰ Ibid. Foreword, the first paragraph.

⁴¹ See paragraphs 73, 78-82 and 87 of the Legislative Guide.

⁴² See e.g., paragraphs 70, 71, 89, 96, 110, 123 and 125 of the Legislative Guide.

2 March 2005⁴³ as it relates to procurement, and to instigate activities to ensure progress towards the procurement-related targets, approved the Methodology for Assessment of National Procurement Systems (Version 4) for testing and application.⁴⁴ The methodology is intended to provide a common tool that developing countries and donors can use to assess the quality and effectiveness of national procurement systems. Such assessment will provide a basis upon which a country can formulate a capacity development plan to improve its procurement system while donors can develop strategies for assisting the capacity to develop, plan and mitigate risks in the individual operations that they decide to fund. The long-term goal is that countries will improve their national procurement systems to meet internationally recognized standards enabling greater effectiveness in the use of funds to meet country obligations. The methodology will be tested at a country level during the coming years until the next High-Level Forum on Aid Effectiveness expected to be held in 2008.⁴⁵ The results of these field tests and the lessons learned from these experiences will be used to improve and refine the tool and the methodology.⁴⁶

OECD Good Practices for Integrity and Corruption Resistance in Procurement

23. At the 2004 OECD Global Forum on Governance “Fighting Corruption and Promoting Integrity in Public Procurement”, focused on steps to enhance integrity and corruption resistance in public procurement, in particular in relation to ensuring that: public procurement procedures are transparent, that there is reliable and fair and equal treatment for bidders; that public resources linked to public procurement are used in accordance with intended purposes; that procurement officials’ behaviour and professionalism is in line with the public purposes of their organization; and that systems are in place to challenge public procurement decisions, ensure accountability, and promote public scrutiny.

24. The OECD approach is to consider public procurement from a good governance perspective, and focuses on the role of transparency and accountability. Its activity is complementary to multidisciplinary efforts in the OECD to improve public procurement systems in OECD and other countries, including the development of a Common Benchmarking and Assessment Tool for Public Procurement Systems for developing countries by the Aid Effectiveness and Donor Practices Working Party of the Development Assistance Committee,⁴⁷ and surveys in the European Union member states of central public procurement organization and

⁴³ See www.aidharmonization.org/.

⁴⁴ The document consists of the User’s Guide, Baseline Indicators (on legislative and regulatory framework, institutional framework and management capacity, procurement operations and market practices, and integrity and transparency of the public procurement system), Compliance and Performance Indicators and Sheet, and International Good Practice Information. Available in English, French, Portuguese and Spanish, as of 8 February 2007, at www.oecd.org/document/40/0,2340,en_2649_19101395_37130152_1_1_1_1,00.html.

⁴⁵ The process and criteria to be used for the selection of pilot countries can be found in the summary of the meeting of the Joint Venture (New York, 13-14 September 2006), paragraph (e), at www.oecd.org/document/23/0,2340,en_2649_19101395_37589271_1_1_1_1,00.html (as of 8 February 2007). The list of twenty-two countries selected for the pilot exercise can be found at www.oecd.org/document/36/0,2340,en_2649_19101395_37849828_1_1_1_1,00.html (as of 8 February 2007).

⁴⁶ For further information on the activities of the Joint Venture and documents issues within its auspices, see www.oecd.org/departement/0,2688,en_2649_19101395_1_1_1_1,00.html.

⁴⁷ See www.oecd.org/document/40/0,2340,en_2649_19101395_37130152_1_1_1_1,00.html.

capacity, performance and efficiency as well as review and remedies systems by the SIGMA (Support for Improvement in Governance and Management) Programme.⁴⁸

25. Further to these activities, the OECD held a symposium entitled “Mapping out Good Practices for Integrity and Corruption Resistance in Procurement”, and a forum entitled “Forum for Policy Dialogue with Non-Members: Sharing Lessons on Promoting Good Governance and Integrity in Procurement” from 29 November to 1 December 2006, as a result of which the OECD will publish a Good Practice Report in the near future, which will map out good practices, and particular approaches, measures and tools that have proved successful in promoting integrity in public procurement in countries across the world.⁴⁹

K. Security Interests

Hague Conference

26. A commercial edition of the Explanatory Report on the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities held with an Intermediary (Hague Securities Convention) was published in 2005. The Report provides the most authoritative and comprehensive explanations of the Convention and is available on the website of the Hague Conference. On 5 July 2006, the USA and Switzerland both signed the Securities Convention. The consultation process within the EC regarding the ratification of the Convention by its Member States and the accession by the EC continues. The Hague Conference also continued to offer some guidance on the conflict-of-laws chapter of the draft Legislative Guide on Secured Transactions prepared by UNCITRAL.

Unidroit

Draft convention on substantive rules regarding intermediated securities

27. At its third meeting, held in Rome from 6 to 15 November 2006, the Unidroit committee of governmental experts considered the Preliminary draft Convention on Substantive Rules regarding Intermediated Securities, as adopted by the Committee at its second session, held in Rome, from 6 to 14 March 2006 (Unidroit 2006 Study LXXVIII Doc. 42; hereinafter the “draft Convention”). The fourth session of the committee is expected to take place in Rome from 21 to 25 May 2007.

28. At its thirty-ninth session in 2006, UNCITRAL considered and approved in principle the recommendations of the UNCITRAL draft Legislative Guide on Secured Transactions (hereinafter “the draft Guide”). At its eleventh and twelfth sessions held in December 2006 and February 2007, Working Group VI (Security Interests) completed its work on the draft Guide and submitted it for adoption by the Commission at its current session (for the reports of Working Group VI, see A/CN.9/617 and A/CN.620; for the draft Guide see A/CN.9/631 and Addenda).

29. At its eleventh session, Working Group IV (Security Interests) agreed that the draft Guide should cover security rights in directly held securities (see A/CN.9/617, paras. 14-16). At the twelfth meeting of Working Group VI (Security Interests), the

⁴⁸ SIGMA is a joint initiative of the OECD and the European Union, principally financed by the EU. See www.oecd.org/LongAbstract/0,2546,en_2649_34121_2345021_119817_1_1_1,00.html.

⁴⁹ Further information and documents from the forum and symposium are available at www.oecd.org/gov/ethics.

Working Group considered the matter again. Various views were expressed as to whether the draft Guide should address security rights in certain directly held securities (see A/CN.9/620, paras. 99-107). At that session, the Working Group agreed that the exclusion of directly-held securities from the scope of the draft Guide should be retained in square brackets for the Commission to consider the matter (see A/CN.9/631, recommendation 4, subparagraph (c), in which the term “intermediated” is retained in square brackets and in which reference is made to the definitions of the Unidroit draft Convention).

Principles and rules on trading in securities in emerging markets

30. Unidroit is preparing an instrument on principles and rules capable of enhancing trading in securities on emerging markets. The Secretariat has commenced preparatory work. The setting up of one or more (regional) Study Group has been authorized by the Governing Council. However, no meeting is expected to be convened before the Committee of governmental experts on intermediated securities will have finalised its work.

Other work relating to capital-markets

31. Studies have been announced on Standardized “global shares”, the legal framework regarding “delocalized” transactions and worldwide take-over bids.

Preliminary draft model law on leasing

32. To further coordination efforts, the Secretariat of Unidroit and UNCITRAL agreed to make a joint proposal to the Unidroit Committee of governmental experts for the preparation of a draft model law on leasing, which will hold its first session in Johannesburg from 7 to 10 May 2007.

33. The purpose of this proposal is to avoid overlap and conflict between the draft Guide and the draft Model Law on leasing. According to this proposal, the terms “security right” (a term used in the context of the unitary approach to acquisition financing) and “acquisition financing right” (a term used in the context of the non-unitary approach to acquisition financing) are defined in the draft Guide in such a way as to include only those leases that are the functional equivalent of a secured transaction and the preliminary draft model law will not apply to a leasing agreement that creates a security right or an acquisition financing right, as defined in the draft Guide.

Protocols to the Cape Town Convention

34. The Luxembourg Protocol to the Convention on International Interests in Mobile Equipment on Matters specific to Railway Rolling Stock (the Rail Protocol) was adopted and opened to signature on 23 February 2007 by a diplomatic Conference held in Luxembourg, under the joint auspices of Unidroit and the Intergovernmental Organisation for International Carriage by Rail (OTIF), at the invitation of the Government of Luxembourg.

35. Intersessional work continues in respect of the preliminary draft Protocol to the Convention on International Interests in Mobile Equipment on Matters specific to Space Assets. This intersessional work, which includes a Government/industry forum, hosted by the Royal Bank of Scotland in London on 24 April 2006, is designed to permit the reconvening of the Unidroit Committee of governmental

experts for the preparation of a draft Protocol to the Convention on International Interests in Mobile Equipment on Matters specific to Space Assets and the timely completion of said draft Protocol. It is hoped that a further joint Government/industry meeting, to be held in New York on 19 and 20 June 2007, will pave the way for reconvening the Committee of governmental experts in Autumn 2007.

36. An additional Protocol to the Cape Town Convention on Matters specific to Agriculture, Mining and Construction Equipment is also under consideration.

EC

The proposal for a regulation on the law applicable to contractual obligations (Rome I)

37. On 15 December 2005, the European Commission published its proposal (COM (2005) 650 final, 2005/0261) for a regulation of the European Parliament and the Council on the law applicable to contractual obligations (Rome I).⁵⁰ Article 13 (3) adopts the law of the assignor's habitual residence for third-party effects of assignment. According to the comment to article 13 (3), the approach adopted is the approach of the United Nations Assignment Convention. Article 18, however, defines habitual residence by reference to the principal place of business (the term "establishment" is used) and, if there is a branch office, the location of the branch office. There is no comment to article 18 pointing out the difference with the location rule in the United Nations Assignment Convention (referring to the place of the assignor's central administration), as a result of which the law applicable under the proposed regulation article 13 (3) may be different from the law applicable under article 22 of the United Nations Assignment Convention.

38. On 13 September 2006, the European Economic and Social Committee issued an opinion (INT/307, Contractual obligations (Rome I)) on the Proposal for a Regulation of the European Parliament and of the Council on the law applicable to contractual obligations (Rome I).⁵¹ The Committee welcomed the Commission's plan for a regulation on conflict-of-law rules in the field of contractual obligations and expressed its belief that the regulation will develop European conflict-of-law rules in a logical way and close a loophole in the current system of Community law. According to the Committee, the regulation is useful and necessary for the development of a single European area of justice, since the 1980 Rome Convention that currently regulates this field is in need of modernization but, as a multilateral agreement, the prospects of that happening are doubtful and would in any case involve time-consuming negotiations. The Committee urged the Community legislative bodies to incorporate certain amendments.⁵²

39. With respect to the law applicable to the proprietary effects of assignments of receivables, the Committee noted that: "Voluntary assignment and contractual subrogation of the creditor's rights from the creditor to a third party discharging the debt, which is a feature of many systems of law, serve the same purpose in economic terms. The proposed text does well to deal with both in Article 13. Article 13 (3) introduces a new conflict-of-law rule on the question of which law

⁵⁰ http://eur-lex.europa.eu/LexUriServ/site/en/com/2005/com2005_0650en01.pdf.

⁵¹ <http://eescopinions.eesc.europa.eu/eescopiniondocument.aspx?language=en&docnr=1153&year=2006>.

⁵² <http://europa.eu/bulletin/en/200609/p119008.htm>.

should determine whether the assignment may be relied on against third parties. This rule rightly follows the solution adopted by the United Nations Convention on the assignment of receivables in international trade of 12 December 2001”.⁵³

OAS⁵⁴

40. The OAS, through its sixth Inter-American Specialized Conference on Private International Law (CIDIP VI), continued its work on the development of uniform Inter-American registration forms as well as regulatory guidelines for secured transactions registries, and the electronic operation thereof, for implementation in conjunction with the Model Law.⁵⁵

WIPO

41. WIPO cooperated with the Secretariat in the organization of a Colloquium on Security Interests in Intellectual Property, which was held in Vienna on 18 and 19 January 2007. The Commission will have before it a report on the Colloquium with suggestions for future work by the Commission (see A/CN.9/632).

⁵³ See endnote 5.

⁵⁴ www.oas.org.

⁵⁵ www.oas.org/main/main.asp?sLang=E&sLink=http://www.oas.org/dil/.

Part Three

ANNEXES

I. SUMMARY RECORDS OF THE MEETINGS OF THE UNITED NATIONS COMMISSION ON INTERNATIONAL TRADE LAW DEVOTED TO THE DRAFT UNCITRAL LEGISLATIVE GUIDE ON SECURED TRANSACTIONS AND POSSIBLE FUTURE WORK

Summary record of the 836th meeting, held at the Vienna International Centre on Monday, 25 June 2007, at 10 a.m.

[A/CN.9/SR.836]

Temporary Chairman: Mr. Sekolec (Secretary of the Commission)

Chairman: Mr. Mitrović (Serbia),

(Later) Chairman: Ms. Sabo (Chairperson of the Committee of the Whole) (Canada)

The meeting was called to order at 10.05 a.m.

Opening of the session

1. **The Temporary Chairman** opened the fortieth session of the United Nations Commission on International Trade Law (UNCITRAL, hereinafter referred to as “the Commission”).

Election of officers

2. **Mr. Borisov** (Russian Federation) nominated Mr. Dorbosav Mitrović (Serbia) for the office of Chairman.

3. **Ms. Sabo** (Canada) seconded the nomination.

4. *Mr. Dorbosav Mitrović (Serbia) was elected Chairman by acclamation.*

Adoption of the agenda (A/CN.9/613)

5. *The agenda was adopted.*

6. **The Chairman**, noting that the Commission was meeting as a Committee of the Whole for the consideration of agenda item 4, invited members to elect a Chairperson.

7. **Mr. Deniau** (France) nominated **Ms. Kathryn Sabo** (Canada) for the office of Chairperson.

8. **Mr. Sigman** (United States of America) and **Mr. Patch** (Australia) seconded the nomination.

9. *Ms. Sabo (Canada) was elected Chairperson of the Committee of the Whole by acclamation and took the Chair.*

Adoption of a draft UNCITRAL Legislative Guide on Secured Transactions and possible future work (A/CN.9/617, 620, 631 and Add.1-11, 632 and 633)

10. **The Chairperson** drew attention to documents A/CN.9/631 and Add.1 to 11 containing revised recommendations and commentaries pertaining to the draft UNCITRAL Legislative Guide on Secured Transactions (hereinafter referred to as “the Guide”) and to documents A/CN.9/617 and A/CN.9/620 containing the reports of Working Group VI (Security Interests) on its eleventh and twelfth sessions.

11. She invited the Commission to begin its consideration of the draft Guide with chapter VII concerning the priority of a security right as against the rights of competing claimants.

VII: Priority of a security right as against the rights of competing claimants (A/CN.9/631 and Add.4)

A. General recommendations (recommendations 74 to 98)

Recommendations 74 to 83

12. *Recommendations 74 to 83 were adopted.*

Recommendation 84

13. **Mr. Bazinas** (Secretariat) said that recommendation 84, which was in square brackets, addressed the question of whether a transferee of an encumbered asset took the asset free of a security right that had been made effective against third parties by registration in a specialized registry or notation on a title certificate. The Committee might wish to consider whether recommendation 85 was sufficient to cover that situation.

14. **Ms. Walsh** (Canada) said that, in her view, recommendation 85 needed to be supplemented. However, recommendation 84, as currently worded, failed to reflect the applicable rule, namely that priority should be given to an interest that came within the scope of a specialized registry, whether the interest was that of a buyer, a secured creditor or any other party whose rights were to be protected. She noted that recommendation 93, which dealt with a similar issue in the context of registration of an attachment in an immovable property registry, stated that any right — of a buyer, a lessee or any other party — registered in the immovable property registry had priority over a security right registered only in a general security rights registry. She therefore suggested that the wording of recommendation 84 should be aligned with that of recommendation 93.

15. **Mr. Umarji** (India) expressed support for that proposal.

16. **Mr. Sigman** (United States of America) expressed support for the Canadian proposal in principle. He pointed out, however, that recommendation 93 dealt with the priority contest between any type of right registered in an immovable property or specialized registry and a security right registered in the general registration system, whereas recommendations 84 and 85 dealt with the situation of any type of transferee vis-à-vis a security right.

17. **Ms. Walsh** (Canada) proposed deleting the word “security” before “right” in recommendation 84 in order to extend its coverage to rights other than security rights.

18. **Mr. Riffard** (France) said it was unclear to him what kind of conflict of priority such an amended version of recommendation 84 was intended to address. If it was a conflict of priority between the holder of “a right” registered in a

specialized registry and a buyer or transferee, he wondered whether it came within the scope of the draft Guide.

19. **Mr. Deschamps** (Canada) noted that recommendation 85 provided that the buyer of an asset subject to a security right that was effective against third parties at the time of the transfer took its rights subject to the security right, except as provided in recommendations 86 to 88. The aim of recommendation 84 was to establish a similar rule for security rights in assets made effective against third parties by registration in a specialized registry or notation on a title certificate. If a security right had been registered only in the general security rights registry, the buyer would acquire the asset free of the security right.

20. **Mr. Riffard** (France) suggested combining the principles underlying the two recommendations in a single text for the sake of clarity. The draft Guide was intended as a tool for legislators and must therefore be easy to understand for all users, including those without specialized knowledge in the area of secured transactions.

21. **Mr. Sigman** (United States of America) said he was not convinced that combining the two recommendations would simplify matters because recommendation 84 addressed the question of registration or non-registration in a specialized registry, while recommendation 85 addressed registration in a general security rights registry except as provided in recommendations 86 to 88.

22. In any case, he proposed replacing “the security right” in the second line of both recommendation 84 and recommendation 85 by “a security right”.

23. **Mr. Bazinas** (Secretariat) explained that recommendation 84 had been drafted separately because of the importance of the principle that a security right or any other right registered under a specialized regime should have priority over a security right registered in the general security rights registry. The intellectual property community, for example, had highlighted the need for a clear rule on the matter.

24. **Ms. McCreath** (United Kingdom) proposed amending the first sentence of recommendation 84 to read: “... if a right in an encumbered asset is transferred and that right is made effective ...”.

25. **Mr. Sigman** (United States of America) said he disagreed with the amendment proposed by the representative of the United Kingdom. The word “security” before “right in an encumbered asset” in the opening phrase of recommendation 84 had been deleted, so that the phrase now referred to any type of transferee and a distinction had to be made between the right in question and a security right in the asset.

26. **The Chairperson** said she took it that the Commission wished to delete the word “security” in the first line of recommendation 84 and to replace the words “the security right” by “a security right” in the second line of recommendations 84 and 85.

27. *It was so decided.*

28. *Recommendations 84 and 85, as amended, were adopted.*

Recommendation 86

29. **Mr. Riffard** (France) expressed support for the suggestion made in the “Note to the Commission” to delete subparagraph (b)(ii) of recommendation 86.

30. **The Chairperson** said she took it that the Committee wished to delete subparagraph (b)(ii).

31. *It was so decided.*

32. *Recommendation 86, as amended, was adopted.*

Recommendation 87

33. **Mr. Sigman** (United States of America) proposed deleting the words “or consumer goods” in recommendation 87 (a). If consumer goods were purchased in the ordinary course of a seller’s business, they constituted inventory for the seller and consumer goods only for the buyer.

34. **Ms. Walsh** (Canada) said that both “consumer goods” and “inventory” referred to the use to which goods were put by a particular person rather than to qualities inherent in the goods. She therefore proposed amending the opening phrase of recommendation 87 (a) to read: “A buyer of goods sold in the ordinary course of a seller’s business ...”. Similarly, the opening phrase of recommendation 87 (b) would read: “... a person that accepts a lease of goods leased in the ordinary course of the lessor’s business ...”.

35. **Mr. Voulgaris** (Greece), **Mr. Sigman** (United States of America) and **Mr. Ekedede** (Nigeria) supported the amendment proposed by the representative of Canada.

36. **Mr. Schneider** (Germany) said that while he concurred with the comment by the representative of Canada regarding the use of the terms “inventory” and “consumer goods”, he felt it might be preferable to replace “goods” with “tangible property”.

37. **The Chairperson** noted that the proposal would also obviate potential difficulties in translating the term “goods”.

38. **Mr. Weise** (Observer for the American Bar Association) said that if the term “consumer goods” was deleted, the sale of consumer goods by individuals in their personal capacity, which by definition did not constitute transactions carried out in the ordinary course of business, would not be covered by the recommendation.

39. **Ms. Walsh** (Canada) expressed the view that such situations were covered by recommendation 85. The “ordinary course of business” rule was an exception to the rule contained in that recommendation.

40. She noted that the word “goods” was used in recommendation 106 regarding goods covered by a negotiable document.

41. **Mr. Weise** (Observer for the American Bar Association) said that he was concerned that a buyer of consumer goods might be unable to take its rights free of the security right where the buyer did not know that it was violating the rights of the secured creditor of the seller of the consumer goods.

42. **Mr. Patch** (Australia) agreed that a consumer who bought goods informally from another consumer should take them free of any security interest pertaining to the seller.

43. **Ms. Walsh** (Canada) suggested stating in the recommendation that in consumer-to-consumer transactions States might wish to consider such an exception in respect of very low-value goods, but that as a general rule a consumer who had made a purchase on secure financing terms should not be free to sell a high-value item free of the security right.

44. **Mr. Umarji** (India) agreed that security rights must continue to apply to consumer-to-consumer

transactions. It was unacceptable for buyers to extinguish the security right by selling valuable consumer goods to a third party.

45. **Ms. Stanivuković** (Serbia) proposed that the original wording should be retained, since the terms “inventory” and “consumer goods” had been defined in document A/CN.9/631/Add.1. She felt it might be dangerous to broaden the scope of the exception to the general rule contained in recommendation 87.

46. **Mr. Bazinas** (Secretariat) said that the term “tangible property” could be used in place of both “inventory” and “consumer goods”.

47. **Ms. Walsh** (Canada), supported by **Mr. Wiegand** (Switzerland), said that using terms such as “inventory” or “consumer goods” in conjunction with the phrase “in the ordinary course of business” implied that a person, in order to qualify for protection, must show both that it had purchased the goods in the ordinary course of business and that the goods qualified as inventory or consumer goods, whereas “in the ordinary course of business” was the key criterion for obtaining protection. She proposed that the references to consumer goods and inventory in recommendation 87 (a) and (b) should be replaced by the phrase “tangible property other than negotiable instruments and negotiable documents”.

48. **Mr. Sigman** (United States of America) expressed support for the proposal.

49. **The Chairperson** said she took it that the Committee wished to adopt the amendment proposed by the representative of Canada.

50. *It was so decided.*

51. *Recommendation 87, as amended, was adopted.*

Recommendations 88 to 98

52. *Recommendations 88 to 98 were adopted.*

B. Asset-specific recommendations (recommendations 99 to 107)

Recommendations 99 to 106

53. **Ms. Perkins** (United Kingdom) said that recommendation 99 was ambiguous in terms of its application to securities.

54. Moreover, recommendations 99 to 106 were inconsistent in terms of their application to financial

contracts, since they addressed security rights in letters of credit and rights to payment of funds credited to a bank account but not in derivatives.

55. **The Chairperson** suggested deferring discussion of those issues until it took up the question of the application of the draft Guide to securities and financial contracts.

56. *It was so decided.*

Recommendation 107

57. **The Chairperson** drew attention to the alternative wording of recommendation 107 suggested by the Secretariat.

58. **Ms. Walsh** (Canada) expressed support for the Secretariat’s version because the current wording dealt only with a situation involving competition between two security rights in a negotiable document, whereas competition could arise between the holder of a security right and a person such as a buyer of goods covered by the document of title to whom the document was transferred in the ordinary course of business. For instance, a buyer who had purchased goods by accepting possession of a document of title such as a bill of lading would take precedence over the holder of a registered security right because that was the accepted practice and the reasonable expectation in shipping circles.

59. **Mr. Riffard** (France) also expressed support for the Secretariat’s version but proposed adding the words “covering the goods” after “the security agreement” at the end of the recommendation.

60. **Mr. Umarji** (India) expressed a preference for the Secretariat’s version, since it upheld the primacy of the law governing negotiable documents.

61. **Mr. Sigman** (United States of America) expressed support for the Secretariat’s version without the amendment proposed by the representative of France. Under recommendation 29, a security right in a negotiable document automatically entailed a security right in the goods covered by the document. The proposed amendment might cast doubt on that principle.

62. **Mr. Weise** (Observer for the American Bar Association) noted that the Secretariat’s version considerably broadened the scope of the recommendation. In the new version, a security right in a negotiable document took precedence over a security right in the goods covered by that

document, even if the latter right had been obtained before or after the period to which the negotiable document related.

63. **Mr. Deschamps** (Canada) proposed deleting “in good faith” since its meaning overlapped with that of the phrase “without knowledge that the transfer is in violation of the rights of the secured creditor”.

64. **Mr. Affaki** (Observer for the International Chamber of Commerce) suggested that it would be preferable to delete the phrase beginning “without knowledge ...”. To the extent that the security right was taken through possession of the negotiable document for value in good faith, it was no longer necessary — indeed it would be contrary to established practice in the shipping world — to require the secured party who took possession of the negotiable document to make sure that there was no earlier security right.

The meeting rose at 12.30 p.m.

**Summary record of the 837th meeting, held at the Vienna International Centre
on Monday, 25 June 2007, at 2 p.m.**

[A/CN.9/SR.837]

Chairman: Ms. Sabo (Chairperson of the Committee of the Whole) (Canada)

The meeting was called to order at 2.05 p.m.

Adoption of a draft UNCITRAL Legislative Guide on Secured Transactions and possible future work (continued) (A/CN.9/617, 620, 631 and Add.1-11, 632 and 633)

VII: Priority of a security right as against the rights of competing claimants (continued) (A/CN.9/ 631 and Add.4)

B. Asset-specific recommendations (continued) (recommendations 99 to 107)

Recommendation 107 (continued)

1. **Mr. Wiegand** (Switzerland) expressed support for the proposal by the representative of Canada to delete the reference to “good faith” from the Secretariat’s proposed new version of recommendation 107. The phrase “without knowledge that the transfer is in violation of the rights of the secured creditor under the security agreement” should be retained since in many jurisdictions a secured creditor, buyer or other transferee was not permitted to acquire rights if it knew of any competing rights.

2. **Mr. Pendón Meléndez** (Spain) said that while recommendations 99 to 105 referred explicitly to priority, recommendation 106 adopted a negative approach, referring to subordination. He submitted that if recommendation 106 were expressed more clearly and brought into line with the other recommendations, it might be possible to dispense with recommendation 107 altogether. If it was retained, however, recommendation 107 would need to be redrafted for ease of interpretation. For instance, it referred to “taking possession” of a negotiable document, whereas the key issue was that of title. He also had reservations about the term “violation” of the rights of the secured creditor since two security rights could validly coexist.

3. **Mr. Riffard** (France) said that the Secretariat’s version of recommendation 107 rightly accorded

priority to a secured creditor, buyer or other transferee that was in possession of the negotiable document. However, it failed to address a potential conflict, which had been dealt with in the original version, between a creditor that had a security right in a negotiable document made effective by registration and a creditor that had a security right in the goods covered by the document. If the new version was adopted, it would be necessary to rectify that omission.

4. **Mr. Kohn** (Observer for the Commercial Finance Association) said that the Secretariat’s suggested version had serious implications for inventory acquisition financiers. Under the previous version, for instance, where a borrower deposited goods obtained from an inventory acquisition financier in a warehouse and pledged the warehouse receipts to a new lender, the first lender would retain priority. Under the new version, the borrower could deposit the goods in a warehouse, pledge the receipts and defeat the inventory acquisition financier’s security interest. His organization therefore considered that the original wording should be retained.

5. **Mr. Schneider** (Germany) concurred with the previous speaker.

6. If the new version was nonetheless adopted, it should maintain the references both to “good faith” and to “without knowledge that the transfer is in violation of the rights ...”.

7. **Ms. Walsh** (Canada) said that while she shared the concern expressed by the observer for the Commercial Finance Association regarding a situation in which the same grantor created two security rights, one made effective by registration and the other by handing over possession of a document of title, it was her understanding that the recommendation was intended to deal with the contest between a secured creditor that took security from a grantor that owned inventory and a second

secured creditor that took security from a buyer of the inventory by taking possession of a bill of lading representing the inventory. The problem could be resolved by amending the text of the Secretariat's suggested version of the recommendation to read: "The law should provide that a security right in goods covered by a negotiable document is subordinate to the rights of a secured creditor, buyer or other transferee that takes possession of a document of title in the grantor's, seller's or other transferor's ordinary course of business ...". That wording would exclude the situation in which a grantor handed over a document of title to a second secured creditor, since that was not a transaction conducted in the ordinary course of business but double dealing with security rights.

8. To deal with the reservation regarding recommendation 106 expressed by the representative of France, she proposed amending it to read: "The law should provide that a security right in a negotiable document or the goods covered thereby is subordinate to the rights of a secured creditor, buyer or other transferee who takes possession of the negotiable document in the grantor's, seller's or other transferor's ordinary course of business."

9. **Mr. Weise** (Observer for the American Bar Association) expressed the view that it was appropriate to deal with security rights arising in connection with bills of lading separately from those arising in connection with warehouse receipts. The risk of double financing of the same goods was less likely to arise in the case of a bill of lading than in the case of a warehouse receipt.

10. **Ms. Walsh** (Canada) said that warehouse receipts should be addressed because in shipping transactions the bill of lading was frequently replaced by a warehouse receipt at the port of unloading before delivery to the purchaser. Of course, the warehouse receipt had to comply with the definition of a document of title and the law of the State concerned must recognize the negotiability of such a receipt. The issue could be resolved by simply deleting recommendation 107, but the Working Group had felt that secure transactions law should spell out the substantive law as clearly as possible.

11. **Mr. Pendón Meléndez** (Spain) said that a prior security right in goods took precedence over a subsequent "document of title", a term that he felt was creating confusion. The security right that a bank obtained from the mere possession of a bill of lading or a warehouse receipt was very different from a security right stemming from a securities regime or from a previously constituted security right. It would perhaps be preferable to emphasize the general rule contained in recommendation 106 and to dispense with recommendation 107.

12. **Mr. Bazinas** (Secretariat) said that, as he understood it, recommendation 106 was intended to deal with a conflict between a secured creditor that had obtained a security right under the law on secured transactions and a secured creditor that had obtained a security right under the law governing negotiable documents by negotiating the negotiable document. Recommendation 107, on the other hand, was intended to deal with a conflict of priority between two secured creditors that had both obtained security rights under the law on secured transactions, one by taking possession of the negotiable document and the other by obtaining a security interest in the goods or by some means other than taking possession of the negotiable document, in which case the former would prevail. However, the Committee might still consider that recommendation 106 was sufficient and that recommendation 107 could be deleted.

13. **Mr. Kohn** (Observer for the Commercial Finance Association) said that, in his opinion, recommendation 107 was worth retaining. He supported the wording suggested by the Secretariat, with the amendment proposed by Canada. He also proposed that the commentary address the concerns that had been raised in the discussion.

14. **Mr. Cohen** (United States of America) said that, as he understood it, recommendations 106 and 107 dealt with different situations. Recommendation 106 preserved the rights of a person to whom a negotiable document had been duly negotiated and made it clear that the recommendations of the draft Guide did not lessen those rights. Recommendation 107 went beyond that and dealt with the rights of competing parties even where there had not been due negotiation. It seemed in the light of the discussion to deal with a greater

variety of factual situations than had been envisaged at the time of drafting.

15. The amendment proposed by the representative of Canada was a potential solution, but the Committee should see it in writing and consider all its possible implications before deciding whether to adopt it.

16. **Mr. Deschamps** (Canada) said he felt that, in the light of the explanation given by the Secretariat, it might be better to retain the original version of recommendation 107, at least in substance. It should be made clear that recommendation 107 dealt only with a competition between a secured creditor that had taken possession of a negotiable document and a secured creditor that had employed some other means. On balance, he would be willing to omit the question of protection of third-party purchasers from recommendation 107, relying instead on the general principle set out in recommendation 106. If a purchaser was protected, it followed that the secured creditor of the protected purchaser would also be protected.

17. Canada would submit a draft revised text of recommendation 107 to the Committee.

18. **Mr. Affaki** (Observer for the International Chamber of Commerce) said that recommendation 107 addressed a paramount conflict, namely that between a secured creditor that had taken possession of a negotiable document and a secured creditor that had directly obtained security rights in the inventory. He suggested that recommendation 107 should concentrate on that case by reverting to the original wording drawn up by the Working Group. It would then be clear that a secured creditor in possession of a negotiable document, such as a bill of lading, automatically had priority during the period when the negotiable document was in effect, i.e. during the period of the shipment in the case of a bill of lading, without having to demonstrate good faith or the absence of knowledge of any pre-existing security rights.

19. **The Chairperson** suggested that the delegation of Canada, in informal consultation with other interested delegations, should prepare a new draft of recommendation 107 for consideration in due course.

20. *It was so decided.*

Recommendations 101 and 102

21. **Ms. McCreath** (United Kingdom) noted that Working Group VI had agreed at a previous session that recommendation 101 should not be mandatory and that the flexibility of the rule should be highlighted. As the current wording was not sufficiently flexible, she proposed amending the third sentence to read: "If the secure creditor is the depositary bank, unless it otherwise agrees, its security right has priority ...".

22. Recommendation 102 should also be amended to read: "... has priority, unless it otherwise agrees, as against the security right ...".

23. She felt that some of the material in the commentary (A/CN.9/631/Add.4, para. 112) should be reflected in the text of the recommendation itself.

24. **Mr. Deschamps** (Canada), supported by **Mr. Sigman** (United States of America) and **Mr. Rehbein** (Germany), pointed out that there was already a general rule, laid down in recommendation 77, that any secured party might agree to subordinate its priority in favour of another competing claimant. Inserting a provision to that effect in a recommendation dealing with priority might cast doubt on the other priority sections.

25. **Ms. McCreath** (United Kingdom) withdrew her proposed amendment.

26. *Recommendations 99 to 106 were adopted.*

Commentary to chapter VII: Priority of a security right as against the rights of competing claimants (A/CN.9/631/Add.4)

27. **Mr. Bazinas** (Secretariat) said that the commentary consisted of a general part and an asset-specific part. The recommendations, as adopted by the Committee, would be inserted at the end of each chapter. The Committee would need to decide whether a consolidated appendix or separate document containing all the recommendations should also be prepared. The commentary would describe the approaches to secured transactions that the Working Group had deemed to be feasible and the advantages and disadvantages of different approaches to policy issues. It would also present any additional reasoning that would shed light on the final form of the recommendation.

Section A.1 (paras. 1 to 11)

Paragraph 1

28. **Mr. Sigman** (United States of America), replying to a point raised by **Mr. Umarji** (India), proposed clarifying the second sentence of paragraph 1 by amending it to read: “These rules apply whenever at least one of the competing claimants is a secured creditor ...”.

29. *It was so decided.*

30. **Mr. Sigman** (United States of America) said that the most important paragraphs in section A.1 were paragraphs 6 to 9 which clarified the purpose and value of clear and comprehensive priority rules. He therefore suggested, with the support of **Mr. Wiegand** (Switzerland) and **Mr. Riffard** (France), that those paragraphs should be moved to immediately after paragraph 1.

31. **Mr. Macdonald** (Canada) noted that throughout the commentary the drafter frequently signalled an important idea at the outset and subsequently developed its full implications. Paragraph 1, for instance, drew attention to the fact that the term “priority” had different meanings in different legal systems. He was against changing the order of the paragraphs. Some readers might not be familiar with the term “priority” as used in the draft Guide; paragraphs 2 to 5 explained the concept and paragraphs 6 to 9 went on to explain why it was so important.

32. **Mr. Kohn** (Observer for the Commercial Finance Association) supported retaining the original order.

33. **Ms. McCreath** (United Kingdom) suggested that the desired emphasis on the key paragraphs might be achieved by adding the subtitle “Importance of the priority concept” before paragraph 6.

34. *It was so decided.*

Paragraph 4

35. **Ms. Walsh** (Canada) said that paragraph 4 implied that a judgement creditor was always subordinate to a secured creditor. That was not always the case, as the Guide itself stated in recommendation 90. In some cases, a judgement

creditor could obtain priority over later advances by giving notice to a secured creditor. The language of the paragraph should be made less categorical.

36. **Mr. Bazinas** (Secretariat) said that paragraph 4 merely stated the general principle that secured creditors had priority over unsecured creditors and went on to cite the exceptions to that rule.

37. **Mr. Voulgaris** (Greece) said that time was also a factor. Judgement creditors that notified third parties of the ranking of their rights had priority over secured creditors existing at the time the judgement was delivered and afterwards, but not over earlier secured creditors.

38. **The Chairperson** said she took it that the Committee wished to refer in the first sentence to security rights that were effective against third parties and to explain the concept of third-party effectiveness and its relationship to the concept of priority.

39. **Mr. Voulgaris** (Greece) suggested that specific examples should be included, as far as possible, to illustrate the principles stated.

40. *It was so decided.*

Paragraph 5

41. **Ms. Walsh** (Canada) said that a secured creditor that had not made its security rights effective against third parties was in the same position as an unsecured creditor. The first sentence of paragraph 5 stated that principle, but the second sentence added nothing and might even prove confusing. The Secretariat should either reword or delete it. It should be made clear earlier in the text that there could be no issue of priority at all unless the secured creditor had made its security rights effective against third parties.

42. **The Chairperson** said she took it that the Committee wished to make it clear in the second sentence that no issue of priority could arise between security rights that were not effective against third parties.

43. *It was so decided.*

Paragraph 8

44. **Ms. Walsh** (Canada) said that paragraph 8 laid down the important principle that a secured creditor should be able to take priority with respect to the residual value of an encumbered asset after payment of the amount owed to a first secured creditor. The text should perhaps describe the two ways in which that might be done, namely by stating in the registered notice the maximum amount secured by the first-priority ranking security right or, alternatively, by a subordination agreement.

45. **The Chairperson** said she took it that the Committee wished to amend paragraph 8 as proposed by the representative of Canada.

46. *It was so decided.*

Paragraphs 9 to 11

47. **Ms. Walsh** (Canada) expressed the view that paragraph 9 repeated much of the material in paragraphs 6 to 8. Paragraph 10 merely referred to the “Purpose” section of the recommendations on priority without adding anything and paragraph 11 made a statement about conflict of laws that was in fact applicable to all chapters.

48. **Mr. Kohn** (Observer for the Commercial Finance Association) endorsed the comments by the representative of Canada.

49. **The Chairperson** said she took it that the Committee wished to redraft paragraph 9 to make it less repetitive, to flesh out paragraph 10 and to delete paragraph 11.

50. *It was so decided.*

51. *The substance of paragraphs 1 to 11 was approved subject to the agreed amendments.*

*Section A.2 (paras. 12 to 25)**Paragraphs 15 to 18*

52. **Ms. Walsh** (Canada) said that the statement in paragraph 15 that some States did not require registration in the case of consumer goods because a security right in such goods was automatically effective against third parties properly belonged in chapter V, “Effectiveness of a security right against third parties”. Moreover, no explanation for the

adoption of such a rule and no indication of the advantages or disadvantages was provided.

53. Paragraphs 16 to 18 dealt with the point at which third-party effectiveness was achieved and therefore also belonged in chapter V. She suggested that a cross-reference to that chapter should be inserted wherever appropriate in the discussion of priority rules based on registration.

54. **The Chairperson** said she took it that the Committee wished to limit the content of paragraphs 15 to 18 to priority issues.

55. *It was so decided.*

Paragraphs 20 to 22

56. **Mr. Riffard** (France) proposed moving paragraphs 21 and 22 to chapter V, since they seemed to be more relevant to third-party effectiveness than to priority.

57. He further noted that paragraphs 21 and 22 referred to three disadvantages of priority based on possession. A fourth disadvantage was that possession by the secured creditor created problems vis-à-vis the secured creditor’s own creditors inasmuch as it conveyed the impression that the asset was actually owned by the secured creditor.

58. **Ms. Walsh** (Canada) said that the points made in paragraphs 20, 21 and most of 22 had already been made in the commentary to chapter V. They dealt largely with third-party effectiveness based on possession, which was a different concept from priority based on possession. Following a cross-reference to chapter V, the discussion should begin with the question addressed in paragraph 22 concerning whether making a security right effective by possession should give special priority status compared with some other method.

59. **The Chairperson** said she took it that the Committee wished to limit the content of paragraphs 20 to 22 to priority issues and to include a reference to the fourth disadvantage of priority based on possession.

60. *It was so decided.*

Paragraph 23

61. **Ms. Walsh** (Canada) said that paragraph 23 referred to “possession” and “control” as though they were analogous concepts. The difference was that in the case of possession a third party was able to ascertain that the grantor no longer had possession of the encumbered asset, whereas in the case of control a third party would be unable to tell that control had passed from the grantor.

62. **Mr. Sigman** (United States of America) noted that there were elements relating specifically to priority in the concept of control, which should be maintained in the text. However, it was important to keep the concept of possession separate from that of control. The latter had not evolved from the former, as stated in the current text. Moreover, paragraph 23 described control as a form of deemed possession, while the draft Guide went out of its way to explain that there was no such thing as constructive or deemed possession and that the term should be understood to mean actual possession.

63. **The Chairperson** said she took it that the Committee wished to clarify in paragraph 23 that the concept of “control” did not flow from the concept of “possession” and focus on the rule that control gave a superior priority right.

64. *It was so decided.*

Paragraphs 24 and 25

65. **Mr. Schneider** (Germany) said that the section on alternative priority rules (paras. 24 and 25) described only the disadvantages of the “first-to-create” rule, according to which priority was based on the time at which the security right was created. That rule also had advantages, including the fact that credit could be extended immediately after creation of the security right, whereas under the “first-to-register” rule credit could be extended only when the security right had been registered. The disadvantages of the “first-to-create” rule were overstated or even wrongly stated, as in the case of financial leasing.

The meeting was suspended at 3.55 p.m. and resumed at 4.15 p.m.

66. **Mr. Bazinas** (Secretariat) asked for guidance regarding the changes that the Committee wished to

make to paragraphs 24 and 25. It was a fundamental principle of the draft Guide that registration of security rights was a good thing and hence that priority should be given, subject to certain qualifications, to the first-to-register rule. It was therefore inappropriate to give the impression that the first-to-create rule was equally effective. He pointed out in that regard that registration could take place in advance of the creation of a security right.

67. **Ms. Walsh** (Canada) said that paragraphs 24 and 25 dealt with the distinction between legal regimes in which a security agreement automatically became effective against third parties upon conclusion of the agreement and regimes in which further action, referred to by the draft Guide as an act of third-party effectiveness such as registration or taking possession, was required. Those were not alternative priority rules. However, even where a security right became effective against third parties on creation, further priority rules were required to provide for possible exceptions to the general rule, for instance in the case of retention-of-title buyers.

68. **The Chairperson** said she took it that the Committee wished to have paragraphs 24 and 25 recast in a more objective way and to limit their content to issues of priority, avoiding third-party effectiveness issues.

69. *It was so decided.*

70. **Mr. Bazinas** (Secretariat) said that section A.2 was intended as a general introduction, describing the approaches to priority taken in different legal systems. With regard to paragraphs 24 and 25, the problem was that some legal systems made no distinction between creation of a security right, third-party effectiveness and priority. It was therefore difficult to avoid some repetition in the three relevant chapters in order to avoid leaving gaps. However, the Secretariat would revise the text in the light of the discussion and add cross-references where necessary.

Paragraphs 16 and 17

71. **Ms. McCreath** (United Kingdom) said that the system described in paragraphs 16 and 17, in which a security right registered within a “grace period” could take priority over an earlier-registered security right, was currently employed very successfully in

her country. She took issue with the statement in the last sentence of paragraph 17 that the system created “significant uncertainty”. She proposed either deleting the sentence or replacing the word “significant” with “theoretical”.

72. **Mr. Kohn** (Observer for the Commercial Finance Association) said that the need to wait until the expiration of a grace period to achieve certainty with respect to priority entailed a real and significant risk for practitioners in cross-border lending. He felt that the paragraph was accurate as it stood.

73. **Mr. Umarji** (India) said that the grace-period system also existed in his country and made it difficult to obtain the release of a loan before the grace period had expired. The “first-to-register” priority rule advocated in the draft Guide was preferable.

74. **The Chairperson** suggested deleting the final clause of the last sentence in paragraph 17, which would then end with the words “creditor’s priority ranking”.

75. *It was so decided.*

76. **Mr. Macdonald** (Canada) said that in drafting the Guide the Committee had examined a number of effective secured transactions regimes, many of which had proved successful because the practices of the primary players were in line with the existing legal regime in the country concerned. It should be borne in mind, however, that while it was relatively easy for States seeking guidance on secured transactions systems to import legislative regimes, it was far more difficult for them to import complex practices and understandings that had been developed over a long period. The draft Guide should avoid any implication that successful regimes might therefore prove dysfunctional and should seek instead to analyse the reasons for their success so that other States could make judgements regarding the approach that suited them best.

77. **Mr. Burman** (United States of America) said that the purpose of the draft Guide was not to describe existing systems but to assist States that needed to improve their commercial finance law in order to upgrade their economic base. At all stages of the drafting, the Working Group had worked closely with international financial institutions and

international capital market interests to ensure that the suggested solutions could be effectively implemented in developing economies. The Committee should keep that aim in mind rather than merely comparing different systems or defending the merits of a particular regime.

78. **Mr. Kemper** (Germany) said he felt that the wording of paragraph 17 as amended was still too rigid. It did not sufficiently recognize that there could be legitimate grounds for introducing grace periods and that such regimes could operate successfully.

79. **Mr. Voulgaris** (Greece) said that, in his opinion, the draft Guide should describe the existing situation for the benefit of practitioners. It should not suggest solutions or state which solution was the best — that was the task of a model law.

80. **The Chairperson** said that the draft Guide was intended for legislators who wished to introduce or update a secured transactions system. As the objectives approved by the Commission and the discussions in the Working Group had made clear, it was not intended to be a survey of all existing systems. It sought instead to evaluate the options that best met the approved objectives and to provide guidance for legislators, who would have to make the necessary policy decisions.

81. **Mr. Wiegand** (Switzerland) said that the draft Guide should not express a preference for a particular system but make it clear that each system was associated with certain transaction costs. For instance, a system that allowed a grace period would involve some uncertainty.

82. *The substance of paragraphs 12 to 25 was approved subject to the agreed amendments.*

Sections A.3 to A.5 (paras. 26 to 37)

Paragraphs 26 to 33

83. **Ms. Walsh** (Canada) said that paragraphs 26 to 33 (section A.3, “Extent of priority”) dealt with two priority issues. The question of whether a security right secured only the amount extended at the time of conclusion of the security agreement or whether it could also secure future obligations was not a priority issue and had been dealt with in chapter IV of the recommendations entitled

“Creation of a security right”. The priority issue was whether the priority that a secured creditor obtained at the moment of achieving third-party effectiveness or at the time of registration extended to future advances. The Guide recommended that it should. The commentary should make that clear, with appropriate cross-references to chapter IV.

84. Paragraph 31 dealt with the issue of whether it was necessary to specify the maximum amount of a security right in the notice registered in the public registry and in the security agreement. If not, a separate subordination agreement would be required.

85. **The Chairperson** suggested that paragraphs 26 to 33 should refer back to the chapter on creation with respect to the creation of a security right in future advances and clarify that priority extended to future advances as of the time the security right became effective against third parties.

She further suggested that paragraph 31 should be recast to clarify that it addressed an issue that was distinct from the issue of priority in future advances, and to refer to a statement of the maximum amount and subordination.

86. *It was so decided.*

87. *The substance of paragraphs 26 to 37 was approved subject to the agreed amendments.*

The meeting rose at 5 p.m.

**Summary record of the 838th meeting, held at the Vienna International Centre
on Tuesday, 26 June 2007, at 9.30 a.m.**

[A/CN.9/SR.838]

Chairman: Ms. Sabo (Chairperson of the Committee of the Whole) (Canada)

The meeting was called to order at 9.30 a.m.

**Adoption of a draft UNCITRAL Legislative Guide
on Secured Transactions and possible future work
(continued)** (A/CN.9/617, 620, 631 and Add.1-11,
632 and 633)

*Commentary to chapter VII: Priority of a security
right as against the rights of competing claimants
(A/CN.9/631/Add.4)*

Sections A.6 to A.17 (paras. 38 to 105)

Paragraph 75

1. **Mr. Umarji** (India) proposed that the phrase “the lease is entered into” in the first sentence of paragraph 75 should be replaced by the phrase “the licence is entered into”.
2. *It was so decided.*
3. *The substance of paragraphs 38 to 105 was approved subject to the agreed amendment.*

Sections B.1 to B.5 (paras. 106 to 120)

Paragraph 110

4. **Ms. Walsh** (Canada) said that she was unable to accept the assertion in paragraph 110 that the existence of a control agreement functioned like a specialized security rights registry. Third parties had no notice of a control agreement and the draft Guide expressly stated that a bank was not required to disclose the existence of such an agreement. The last sentence of the paragraph was therefore misleading and should be deleted.
5. **Ms. McCreath** (United Kingdom) expressed support for the deletion of the last sentence.
6. *It was so decided.*

Paragraph 112

7. **Ms. McCreath** (United Kingdom) said that paragraph 112 required a change of emphasis since

its current wording was unduly prescriptive and overstated the strength of the depositary bank’s position. Contrary to the statement that banks would be reluctant to enter into control agreements if their set-off rights — which in English law were not security rights — were not preserved, banks in the United Kingdom regularly entered into such agreements and the draft Guide should allow for that practice. Moreover, the paragraph stated that the depositary bank would generally win a priority contest by virtue of its right of set-off. Under English law, however, that was not so to the extent that set-off rights had not already become due, owing or incurred at the time that the new security interest was created. The paragraph was also inconsistent in its description of set-off rights, referring to a “right of set-off under non-secured transactions law” at one point and later placing set-off rights within the confines of the secured transactions regime. She therefore proposed rewording the phrase “by reason of its right of set-off under non-secured transactions law” to read “by reason of its present right of set-off under non-secure transactions law unless it has disappplied such rights”. She further proposed replacing the words “secured transactions regime” by “priorities regime” and deleting the final sentence.

8. **Mr. Smith** (United States of America) said that while he was willing to have the text amended in order to address the specific legal regime and practice of the United Kingdom, the language should nevertheless be general enough to take account of other regimes whose rules were less rigid.
9. **Ms. Walsh** (Canada) said that the law of set-off in her jurisdiction also recognized that, once notification was provided, rights of set-off arising under future obligations were crystallized.
10. **Mr. Voulgaris** (Greece) said that the insertion of the phrase “unless it had disappplied such rights”

and the deletion of the final sentence would create confusion for other legal systems.

11. **The Chairperson** said she took it that the Committee wished to leave it to the Secretariat to find a form of words that met all the points that had been raised.

12. *It was so decided.*

13. *The substance of paragraphs 106 to 120 was approved subject to the agreed amendments.*

14. *The substance of document A/CN.9/631/Add.4 as a whole was approved subject to the agreed amendments.*

*VIII: Rights and obligations of the parties
(A/CN.9/631 and Add.5)*

Recommendations 108 to 113

15. *Recommendations 108 to 113 were adopted.*

Commentary to chapter VIII (A/CN.9/631/Add.5)

Sections A, B and C (paras. 1 to 69)

16. *The substance of paragraphs 1 to 69 was approved.*

17. *The substance of document A/CN.9/631/Add.5 as a whole was approved subject to any modifications necessitated by other amendments to the draft Guide.*

*IX: Rights and obligations of third-party obligors
(A/CN.9/631 and Add.6)*

Recommendations 114 to 127

18. *Recommendations 114 to 127 were adopted.*

Commentary to chapter IX: Rights and obligations of third-party obligors (A/CN.9/631/Add.6)

19. **Mr. Bazinas** (Secretariat) said that the Working Group's approach in drafting chapter IX regarding the rights and obligations of third-party obligors — debtors of receivables, depository banks, issuers of letters of credit or negotiable documents or the persons obligated under a negotiable instrument — had been to defer to other legislation in order to ensure that such assets could be used as collateral for credit without interfering with existing law and practice.

Section A (paras. 1 to 35)

Paragraph 22

20. **Ms. Walsh** (Canada) said that, as it stood, paragraph 22 appeared to imply that banks were afforded special treatment in all jurisdictions and were not required to respond to a notification of a security right in a bank account in favour of a third-party secured creditor. However, some legal systems treated bank accounts in exactly the same way as receivables, and the whole of the commentary relating to receivables was therefore applicable to the obligations of a depository bank in its capacity as a debtor on a receivable. In those jurisdictions, the depository bank had no special status, its consent to an assignment was not required, and it was required to obey a notification for payment to the secured creditor when it was received. The wording of paragraph 22 should be modified to reflect those different approaches.

21. **The Chairperson** said she took it that the Committee wished to approve paragraph 22 subject to the addition of a reference to an approach whereby depository banks were treated in the same way as debtors of receivables and their consent was not required for a security right to be created in a right to payment of funds credited to a bank account.

22. *It was so decided.*

23. *The substance of paragraphs 1 to 35 was approved subject to the agreed amendments.*

24. *The substance of document A/CN.9/631/Add.6 as a whole was approved subject to further editorial amendments.*

X: Post-default rights (A/CN.9/631 and Add.6)

A. General recommendations (recommendations 128 to 161)

Recommendation 128

25. **Ms. McCreath** (United Kingdom) said that the phrase "in a commercially reasonable manner" was unclear and was not addressed in detail in the commentary.

26. **Ms. Walsh** (Canada) said that the draft Guide sought to allow the secured creditor a measure of flexibility in determining the time, manner and

mode of enforcement of security rights in order to ensure that the maximum value was obtained for the collateral in the marketplace. Such flexibility required objective standards to ensure that the secured creditor behaved in a manner that protected the interests of the grantor and third-party creditors. The requirement for rights to be enforced in a commercially reasonable manner aimed at ensuring that the secured creditor acted in a market-sensitive way when liquidating the collateral. That principle was reflected in all jurisdictions.

27. **Mr. Umarji** (India) said that when a secured creditor exercised its right to take possession of securities and sell them, the sale must be conducted in a commercially reasonable manner, which could mean, for example, that food grains seized by a secured creditor could not be sold in the chemicals market. The notion implied that the sale must be properly advertised and that every effort was made to obtain the best price. For the sake of clarity, examples of “commercially reasonable” conduct should be included in the commentary to chapter X.

28. **Ms. McCreath** (United Kingdom) welcomed that suggestion. However, commercial reasonableness on the part of a secured creditor was not limited to achieving the best possible price. She submitted that the phrase was vague and meant different things to different people.

29. **The Chairperson** said that “commercially reasonable” conduct depended on a number of factors, including context-specific circumstances and legislation outside the secured transactions regime. Notwithstanding the difficulty of providing a universally valid definition, the Secretariat would seek to provide guidance in the commentary.

30. **Mr. Bazinas** (Secretariat) said that virtually all legal systems that provided for some flexibility in the enforcement of security rights contained clauses or notions concerning good morals, sound practices and propitious conditions in the local market. Even the most rigid codes tended to provide both for certainty and for a certain amount of flexibility to adjust to local conditions. He pointed out that the draft Guide was not an international convention and that any law enacted would be domestic law referring to domestic notions and applicable in domestic courts.

31. **Ms. McCreath** (United Kingdom) insisted that the examples of what was deemed to be “commercially reasonable” should not focus on achieving the best price but should be more prescriptive regarding the scope of the concept.

32. **Mr. Smith** (United States of America) agreed that commercial reasonableness was not synonymous with obtaining the best price in the marketplace. While the conduct of a secured creditor might be commercially reasonable in terms of standard practice for the sale of encumbered assets, a higher price might have been obtained if the merchant had taken a great deal more trouble to investigate potential buyers; however, such conduct might, in retrospect, be viewed as “unreasonable”. The concept should therefore be interpreted as meaning that the secured creditor obtained a price by making commercially reasonable efforts to dispose of the encumbered asset.

33. **Ms. McCreath** (United Kingdom) suggested that “commercially reasonable” might best be described as “obtaining the best price reasonably obtainable”.

34. **Mr. Ghia** (Italy) expressed support for the Secretariat’s comment on the recommendation and also for the idea of including examples of commercially reasonable conduct in the commentary. The need for adequate publicity and visibility of the sale procedure should be stressed.

35. **The Chairperson** said she took it that the Committee wished to adopt recommendation 128 on the understanding that examples of commercial reasonableness would be included in the commentary.

36. *It was so decided.*

37. *Draft recommendation 128 was adopted.*

Recommendations 129 to 131

38. *Recommendations 129 to 131 were adopted.*

Recommendation 132

39. **Mr. Smith** (United States of America) said that, for the sake of clarity, the phrase “does not affect” in the first sentence of draft recommendation 132 should be amended to read “may not adversely affect”.

40. *Recommendation 132, as amended, was adopted.*

Recommendations 133 to 140

41. *Recommendations 133 to 140 were adopted.*

Recommendation 141

42. **Mr. Macdonald** (Canada) said that he agreed with the suggestion in the Secretariat's note that the last sentence of draft recommendation 141 should be placed in the commentary to chapter X.

43. **The Chairperson** said she took it that the Committee wished to delete the last sentence and place it in the commentary.

44. *Recommendation 141 was adopted on that understanding.*

Recommendation 142

45. *Recommendation 142 was adopted.*

Recommendation 143

46. **Ms. McCreath** (United Kingdom) noted that the provision for objection by a grantor in recommendation 143 (c) was liable to be used by grantors as a delaying tactic to prevent a secured creditor from obtaining possession of an encumbered asset.

47. **The Chairperson** said that the wording of recommendation 143 was a compromise reached after lengthy discussions in the Working Group and reflected a very fine balance struck among the participants.

48. **Mr. Bazinas** (Secretariat) said that the provision had been included because even where a grantor had given its approval at the time of conclusion of the security agreement for extrajudicial possession by the secured creditor of an encumbered asset, the actual act of possession might involve a violation of the grantor's rights, for instance where the grantor had not been duly informed or where the secured creditor had sought to obtain possession in an inappropriate way.

49. *Recommendation 143 was adopted.*

Recommendations 144 to 146

50. *Recommendations 144 to 146 were adopted.*

Recommendation 147

51. **Ms. Okino Nakashima** (Japan), referring to the choice in square brackets between notice "given to" and "received by" addressees of the secured creditor's intention to sell or otherwise dispose of, lease or licence an encumbered asset, asked for clarification of the point at which notice was deemed to have been received. A situation might arise, for example, where written notice delivered by mail failed to reach an absent recipient in due time. She therefore preferred the words "given to".

52. **Mr. Riffard** (France) said that the question of whether notice should be "given" or "received" was of considerable importance. In addition to the time factor described by the representative of Japan, the requirement for a creditor to prove that a debtor had received notice entailed substantial costs. Simple proof of notice given, on the other hand, could be provided easily and at virtually no cost.

53. **Mr. Rehbein** (Germany) said that the question of whether a writing became effective from the point of sending or receipt in a mailbox or by email was a matter for the domestic law of each enacting State. It would not be helpful to lay down a rule that was inconsistent with existing practice in the State concerned.

54. **Mr. Bazinas** (Secretariat) said that there was a third alternative implicit in the text. One could refrain from including any special rule regarding notices in secured transactions law, because of the time and cost implications and hence the possible impact on credit transactions, and instead leave the question to be resolved under other branches of domestic law.

55. **Mr. Smith** (United States of America) said that, in his view, the issue should be addressed in secured transactions law because there were separate considerations as to what constituted notice in the context of secured transactions that might not be reflected in general law. As noted by the representative of France, placing the burden of proof that notice had been received on the secured creditor might increase the cost of credit. The question of what constituted receipt also arose. If the rule

consisted merely of “giving” notice, the secured creditor still had the burden of proving that it had used a specific means of transmission.

56. He proposed stating in the commentary that the general chapter X requirement of good faith and commercial reasonableness was applicable, so that a secured creditor must use a method of providing notice that was reasonably designed to facilitate receipt. Grantors were sufficiently well protected by the notions of good faith and commercial reasonableness without imposing the additional burden on the secured creditor of proving actual receipt.

57. **Mr. Voulgaris** (Greece) expressed support for the point made by the representative of Germany. However, should the Committee wish to establish a universal rule, it would be preferable to opt for receipt of notice, which would also be more consistent with the concept of good faith.

58. **Mr. Macdonald** (Canada), noting that recommendation 145 was expressed in terms of “giving” rather than “receiving” notice, submitted that once a State had decided to permit extrajudicial enforcement, i.e. enforcement outside the normal regime of civil execution of judgements, the standards set forth in recommendation 146 provided adequate protection for the grantor. He also argued that couching recommendations 149 and 150 in terms of “giving” rather than “receiving” would be more compatible with the overall framework of the draft Guide pertaining to extrajudicial enforcement.

59. **Mr. Umarji** (India) said that the way in which notice should be served depended on domestic law. Different provisions could not be applied to service of notice for secured transactions from service of notice for some other purpose.

60. **Mr. Wiegand** (Switzerland) said that the Working Group had decided after much deliberation that notice should be given in the context of extrajudicial disposition of an encumbered asset and that the draft Guide should therefore provide for a special regime governing such notice rather than deferring to local rules.

61. **Mr. Bazinas** (Secretariat) drew attention to article 16 of the United Nations Convention on the Assignment of Receivables in International Trade (United Nations Assignment Convention), according

to which notification of an assignment or a payment instruction was effective when received by the debtor if it was in a language that was reasonably expected to inform the debtor about its contents. It was thus couched in terms of “receiving” and the last phrase was similar to recommendation 147 (c) and the requirement of good faith and commercially reasonable standards referred to by the representative of the United States.

62. **Mr. Ghia** (Italy) said that he preferred the wording “received by”, although it was true that some grantors attempted to shirk their responsibilities by avoiding taking receipt of the notice. Hence receipt should not be a condition *sine qua non*, but “notice given” and good faith principles should prevail in accordance with the relevant domestic law.

63. **Mr. Karako** (Observer for the Commercial Finance Association) said that either wording was acceptable to his organization. However, he suggested that the commentary should describe the benefits of the two options and urge States to set standards and provide definitions of the option chosen. For instance, if the wording “received by” was used, the State should make it clear whether a notice delivered to the borrower’s last known address would be deemed to have been received.

The meeting was suspended at 10.55 a.m. and resumed at 11.25 a.m.

64. **Mr. Smith** (United States of America) said that it had been necessary to use the wording “received by” in the United Nations Assignment Convention because of the potential impact of notification of an assignment or a payment instruction on the debtor of a receivable who was not a party to the secured transaction. A more relevant example was the 2001 Convention on International Interests in Mobile Equipment (“Cape Town Convention”), which required notice to be given by the secured creditor when an international object was the subject of a foreclosure sale and which contained no rule requiring receipt.

65. **Ms. McCreath** (United Kingdom) expressed strong support for the words “given to”. The exact procedure would have to be defined in the contract between the parties.

66. **Mr. Voulgaris** (Greece) said that the procedure for giving notice should be as flexible as possible

because of the difficulty of providing a comprehensive definition of the act of sending or receiving.

67. **The Chairperson** suggested that, in the light of the difficulties involved in defining “receipt”, as highlighted by a number of speakers, the words “received by” should be deleted on the understanding that the commentary would provide a detailed explanation for legislators of the implications of the various ways of giving notice in terms of cost-effectiveness and balancing the interests of the parties. The chapeau of recommendation 147 (a) would thus read: “Provide that the notice must be given to”.

68. *It was so decided.*

69. *Recommendation 147, as amended, was adopted.*

Recommendation 148

70. *Recommendation 148 was adopted.*

Recommendation 149

71. **The Chairperson** suggested that the words “given to” should be used instead of “received by” and “received” in recommendation 149.

72. *It was so decided.*

73. *Recommendation 149, as amended, was adopted.*

Recommendation 150

74. **The Chairperson** said she took it that the Committee also wished to replace the word “received” in square brackets in recommendation 150 with “given”.

75. *It was so decided.*

76. **Mr. Bazinas** (Secretariat) said that the second sentence of recommendation 150, which was enclosed in square brackets, was intended to provide additional protection for a grantor by requiring its affirmative consent in cases where a secured creditor proposed to accept an encumbered asset only in partial satisfaction of a secured obligation.

77. **Mr. Umarji** (India) proposed that the sentence should be included in the recommendation.

78. **Mr. Macdonald** (Canada) said that where a debt was only partially extinguished by the taking of an encumbered asset, it was important for the grantor to know the extent to which it had been released from its obligation. He therefore supported the proposal to remove the square brackets from the second sentence.

79. *It was so decided.*

80. *Recommendation 150, as amended, was adopted.*

Recommendations 152 and 153

81. *Recommendations 152 and 153 were adopted.*

Recommendation 154

82. **Ms. Stanivuković** (Serbia) pointed out that, although the section of the draft Guide under discussion was entitled “Distribution of proceeds of extrajudicial disposition of an encumbered asset”, recommendation 154 dealt with proceeds realized by a judicial disposition or other officially administered enforcement process.

83. **The Chairperson** said that, according to the Secretariat, it would be possible either to delete the word “extrajudicial” from the title of the section or to move recommendation 154 to another section of the draft Guide. She suggested that the matter should be left to the discretion of the Secretariat.

84. *It was so decided.*

85. *Recommendation 154 was adopted on that understanding.*

Recommendations 155 to 161

86. *Recommendation 155 to 161 were adopted.*

B. Asset-specific recommendations (recommendations 162 to 172)

Recommendations 162 to 168

87. *Recommendations 162 to 168 were adopted.*

Recommendation 169

88. **Ms. McCreath** (United Kingdom), asked why a secured creditor needed a court order to enforce a security right in funds deposited with a bank. That

provision was based on the presumption that banks enjoyed a special status, although in some jurisdictions they were treated as debtors of account holders.

89. **Mr. Umarji** (India) said that when an account holder deposited funds with a bank, any withdrawal of the funds was governed by a contract between the account holder and the bank. A third party who was a creditor of the depositor could not direct the bank to transfer funds from the account without a court order unless a prior agreement to that effect existed between the depositor, the creditor and the bank.

90. **Mr. Bazinas** (Secretariat) said that the recommendations defined the term receivable as excluding bank accounts. The Working Group had agreed that receivables owed by banks merited special treatment because the right to payment of funds credited to a bank account was commonly used as collateral.

91. **Mr. Smith** (United States of America) said that it had been the understanding of the Working Group that the rule referred to in recommendation 169 was not specific to banks. It also applied to independent undertakings and to other actors not covered in the draft Guide, such as brokers and other securities intermediaries. When dealing with financial market players and payment, securities and settlement systems, it was important for banks and securities intermediaries to know their customers and to be able to react quickly when funds and securities were being transferred. Trade receivables were an entirely different matter. He noted that, owing to the different regulatory practices involved, payment and securities settlement systems and independent undertakings had been excluded from the United Nations Assignment Convention.

92. **Mr. Deschamps** (Canada) said that while he would not go as far as to say that the aforementioned rule was required for the integrity of the financial system, he could see the rationale for ensuring that a bank account or a bank deposit could not be assigned without the consent of the depository bank. The United Nations Assignment Convention contained a provision to the effect that an anti-assignment clause was not effective against the assignee in the case of a trade receivable, but it recognized the effectiveness of such a clause in the case of other types of receivables.

93. *Recommendation 169 was adopted.*

Recommendations 170 to 172

94. *Recommendations 170 to 172 were adopted.*

Commentary to chapter X: Post-default rights (A/CN.9/631/Add.7)

Section A (paras. 1 to 69)

Paragraphs 38 and 39

95. **Mr. Bazinas** (Secretariat) drew attention to a note following paragraph 39 of the commentary, in which the Secretariat suggested that the Commission consider adding a draft recommendation, in the light of paragraphs 38 and 39 of the commentary, concerning the grantor's right to cure the default and reinstate the secured obligation.

96. **Mr. Cohen** (United States of America) said that he was not in favour of drafting a new recommendation. The primary focus of the draft Guide should remain the law of security rights and the Commission should avoid making a recommendation in an area that pertained to the law of obligations.

97. **Mr. Umarji** (India) said that, to avoid complicating the issue, the grantor's right to cure the default and reinstate the secured obligation should remain a matter for agreement between the parties involved.

98. **Mr. Macdonald** (Canada) suggested inserting a paragraph after paragraph 39 pointing out that such a right was a matter for agreement between the parties.

99. **Mr. Rehbein** (Germany) said that a recommendation on the reinstatement of a secured obligation could be misleading in the context of the draft Guide since it might seem to contradict default clauses in other contexts. He therefore joined the other speakers in rejecting the idea.

100. **The Chairperson** said she took it that the Committee did not wish to issue another draft recommendation but would like to have its views reflected in the commentary.

101. *The substance of paragraphs 38 and 39 was approved subject to the agreed amendments.*

Paragraphs 57 and 58

102. **Mr. Bazinas** (Secretariat) drew attention to a note following paragraph 58 of the commentary, in which the Secretariat suggested that the Commission consider adding a draft recommendation, in the light of paragraphs 57 and 58 of the commentary, concerning the secured creditor's right to take over the management of a business and to sell its assets.

103. **Mr. Umarji** (India) said that, in the event of default on a loan, it was not standard practice for banks to enforce securities in a piecemeal fashion. Following a default in one category of loan, a bank would normally have the option of recalling all loans or even of selling the debtor's entire business as a going concern. While a reference to such practices should be included in the text of the commentary, there was no need for an additional recommendation since it was a matter of contract that should be left to the parties concerned.

104. **Ms. McCreath** (United Kingdom) said she believed it might be useful to contemplate drafting a recommendation.

105. **Mr. Macdonald** (Canada) said that the central issue was not the relationship between the parties but rather the rights of third parties. For instance, some States believed that third parties should be notified about ongoing receivership, whereas other States did not.

106. **Mr. Rehbein** (Germany) said that he would be reluctant to accept a recommendation that encouraged a creditor, especially a bank, to take over the management of a debtor's business. There was abundant jurisprudence regarding the damages and liability incurred by banks in that regard and the commentary could adequately cover that area without the need for an additional recommendation.

107. **Mr. Bazinas** (Secretariat) noted that the draft Guide covered the concept of "all-asset security", i.e. cases where the creditor had a security right in all assets of a debtor's business. The question was whether the recommendations were sufficient to cover the sale of a business as a going concern as opposed to liquidation of its assets in a piecemeal fashion, or whether additional text should be added to the commentary to clarify the issue. For instance, the commentary might indicate that in some cases good faith and reasonable market standards might

oblige the secured creditor to sell the business as a going concern in order to obtain higher value.

108. **Mr. Ghia** (Italy) said that he was reluctant to accept the proposal for a recommendation because it might lead to some overlapping and inconsistency with insolvency legislation. The interests of all creditors needed to be safeguarded in the event of default and, to that end, other kinds of procedures with more general guarantees should be encouraged.

109. **Mr. Riffard** (France) said that he was also reluctant to see the addition of such a recommendation since doing so would open up a Pandora's box, assigning a non-traditional and even inappropriate role to secured creditors. In addition to raising issues of liability, it would also raise issues pertaining to the relationship between the secured creditor and employees of the business.

110. **Mr. Kohn** (Observer for the Commercial Finance Association) said that he fully agreed with the representatives of Germany, Italy and France that there should not be an additional recommendation since the remedies set forth in the existing recommendations were sufficient.

111. **Ms. McCreath** (United Kingdom) said that she was not advocating a mandatory recommendation but merely seeking to ensure that such action remained an available option. Perhaps some text in the commentary to that effect would be acceptable.

112. **The Chairperson** said she took it that the Committee did not wish to issue another recommendation but would like to have its views reflected in the commentary.

113. *The substance of paragraphs 57 and 58 was approved subject to the agreed amendments.*

*Section B (paras. 70 to 99)**Paragraph 92*

114. **Mr. Bazinas** (Secretariat) drew attention to a note following paragraph 92 of the commentary, in which the Secretariat suggested that the Commission consider adding a recommendation that specifically addressed enforcement against proceeds, stating that where proceeds took the form of a special category of assets, such as receivables, enforcement should follow the rules applicable to that category of asset.

115. **The Chairperson** said that, having heard no comments from delegations, she took it that the Committee did not wish to support the proposal for an additional recommendation. She suggested that the commentary should state that where proceeds were of a special category of assets, enforcement should follow the rules applicable to that category of assets.

116. **Mr. Cohen** (United States of America) said that it would be helpful to include a sentence in the commentary to that effect.

117. *The substance of paragraph 92 was approved subject to the agreed amendment.*

Paragraph 93

118. **The Chairperson** asked the Committee whether it wished to consider adding a recommendation that specifically addressed enforcement of security rights in attachments.

119. **Mr. Umarji** (India) said that it was not necessary to add a recommendation in view of the difficulty of enforcing such rights in practice.

120. **Mr. Macdonald** (Canada) noted that the chapters on creation and third-party effectiveness contained specific comments and recommendations regarding a whole series of assets such as attachments to movable property. He took it that the basic purpose of the notes was to have the Commission reflect on whether enforcement should be expressed only in general terms or whether more specific recommendations should be made.

The meeting rose at 12.30 p.m.

**Summary record of the 839th meeting, held at the Vienna International Centre
on Tuesday, 26 June 2007, at 2 p.m.**

[A/CN.9/SR.839]

Chairman: Ms. Sabo (Chairperson of the Committee of the Whole) (Canada)

The meeting was called to order at 2.10 p.m.

**Adoption of a draft UNCITRAL Legislative Guide
on Secured Transactions and possible future work**
(continued) (A/CN.9/617, 620, 631 and Add.1-11,
632 and 633)

Commentary to chapter X: Post-default rights
(continued) (A/CN.9/631/Add.7)

Section B (paras. 70 to 99)

Paragraph 93 (continued)

1. **The Chairperson**, summing up the earlier discussion on the note following paragraph 93, said she took it that the Committee did not wish to add a recommendation that specifically addressed enforcement of security rights in attachments.

2. *It was so decided.*

3. **The Chairperson** said she took it that the Committee agreed with the assumption in the penultimate sentence of paragraph 93 that it would create unnecessary confusion if an enforcement regime other than that generally applicable were to be enacted, and also agreed that the commentary should explicitly state that the draft Guide adopted a similar rule for enforcement against security rights in attachments that were effective as against third parties.

4. *The substance of paragraph 93 was approved subject to the agreed amendment.*

Paragraph 94

5. **The Chairperson** drew attention to a note following paragraph 94, in which the Secretariat suggested that the Commission consider adding a recommendation that specifically addressed how enforcement of security rights in attachments and commingled property was to be effected, depending on separability.

6. **Mr. Macdonald** (Canada) said that, since it had not been considered necessary to insert a new recommendation in the light of paragraph 93, it should not be necessary, by parity of reasoning, to insert a new recommendation in the light of paragraph 94.

7. **The Chairperson** said she took it that the Committee did not wish to issue an additional recommendation in response to the note following paragraph 94.

8. *It was so decided.*

9. *The substance of paragraph 94 was approved.*

Sections A and B (paras. 1 to 99)

Paragraphs 1 to 30

10. *The substance of paragraphs 1 to 30 was approved.*

Paragraphs 31 and 32

11. **Mr. Macdonald** (Canada) reminded the Committee that it had earlier decided to use the wording “given to” rather than “received by” in recommendations 147, 149 and 150 and suggested that the most appropriate place to explain the difference between those terms would be either paragraph 31 or paragraph 32 of the commentary.

12. **The Chairperson** said that the Secretariat would make the necessary changes to incorporate that suggestion.

13. *The substance of paragraphs 31 and 32 were adopted subject to the agreed amendments.*

Paragraphs 33 to 99

14. **The Chairperson** noted that the substance of paragraphs 38, 39, 57, 58, 92 and 94 had already been approved subject to the agreed amendments.

15. *The substance of the remaining text of the commentary in paragraphs 33 to 99 was approved.*

16. *The substance of document A/CN.9/631/Add.7 as a whole was approved subject to the agreed amendments.*

XII: Acquisition financing rights (A/CN.9/631 and Add.9)

A. Unitary approach to acquisition security rights (recommendations 184 to 201)

Recommendations 184 to 191

17. *Recommendations 184 to 191 were adopted.*

Recommendation 192

18. **Mr. Kemper** (Germany) said that the decision taken by the Commission regarding registration and retention of title might ultimately prevent Germany from adopting the draft Guide. As noted by the observer for the European Union, important traditions relating to the issue of retention of title existed under European Community law.

19. **Mr. Schneider** (Germany) expressed concern about the different rules applied in recommendations 189 and 192: while a grace period was allowed in the case of tangible property other than inventory, notification was required in the case of inventory. The recommendations thus catered for the interests of financiers, while sellers of inventory were placed at a disadvantage by the lack of a grace period and the need to provide notification or risk losing their property. The draft Guide had a duty to balance the interests of financiers and sellers of inventory. He therefore proposed that the rule applicable to tangible property other than inventory should also apply to inventory. In any case, the notification provided for in recommendation 192 was unnecessary and would hinder immediate delivery.

20. **Mr. Kemper** (Germany) said that the rules set out in recommendation 189 would be an acceptable framework both for rights in tangible property other than inventory and for rights in inventory.

21. **Mr. Cohen** (United States of America) said he agreed that recommendations which made distinctions between different types of transactions should be explained and justified. In that connection,

he drew attention to paragraphs 114 to 118 of the commentary to chapter XII (A/CN.9/631/Add.9), which explained in detail why the rules on acquisition security rights pertaining to inventory differed from those pertaining to other types of tangible collateral.

22. **Mr. Macdonald** (Canada) said that he was currently unsure whether the commentary dealt either specifically or generally with the observations made by the representatives of Germany.

23. **Mr. Ghia** (Italy) expressed support for the proposal made by the representatives of Germany and requested that its precise content be made available to delegations.

24. **The Chairperson**, noting that the commentary to chapter XII was not yet available in French, suggested that the Committee should resume its discussion of the proposal by the representatives of Germany when the commentary became available in all working languages.

25. **Mr. Kemper** (Germany) said that the amendment that his delegation proposed related to recommendation 192 itself. The wording of the commentary, while also unsatisfactory, remained a side issue.

26. **The Chairperson** said that the additional information contained in the commentary might help other delegations to reach a decision on the recommendation. She took it that the Committee wished to defer a decision until the commentary became available in French.

27. *It was so decided.*

Recommendations 193 to 198

28. *Recommendations 193 to 198 were adopted.*

Recommendation 199

29. **Mr. Bazinas** (Secretariat) said that the question for the Committee to decide was whether the approach taken by recommendation 199 with respect to receivables should also be taken with respect to the proceeds of inventory other than receivables. If it considered that it should, it must then decide whether the rule should be formulated in the same way or, if those types of proceeds were excluded, whether the recommendation should be

reformulated to provide that the super-priority of an acquisition security right should not extend to proceeds of inventory.

30. **Mr. Wezenbeek** (Observer for the European Union) said that the European Community and its member States, as stated in their submission (A/CN.9/633), felt that further work was needed on chapter XII before they could fully support the draft Guide. With regard to the issue of retention of title, a sale of goods in which the vendor contractually retained property until receipt of full payment should be recognized as effective against third parties even without registration of a notice in a security rights registry. A similarly flexible approach should also apply to financial leasing.

31. He also took the opportunity to raise four other concerns mentioned in document A/CN.9/633: the need for the draft Guide to be fully compatible with the Unidroit draft Convention on Substantive Rules regarding Intermediated Securities; the importance of finding the right solution to conflict-of-law issues; a carve-out for the use of collateral comprising “financial contracts”; and the incorporation of relevant intellectual property rights in the draft Guide.

32. **Mr. Schneider** (Germany) expressed concern that property rights had been recharacterized as security rights in the draft Guide and had thereby been downgraded in such areas as financial leasing, sale and lease-back, retention of title, repurchase agreements and other financial contracts. The consequence of such recharacterization in chapter XII, for example, was that registration had become necessary even where the seller or financial lessor was still the owner. As a result, it had also become necessary to employ new terminology. The Committee should be aware that industry in his country was becoming extremely concerned about such developments. One of the main issues was registration of retention of title in cases of financial leasing, which should not be required under any circumstances.

33. **Mr. Riffard** (France) said that a satisfactory agreement on the retention-of-title issue, involving a distinction between the unitary and non-unitary approaches to security rights, had been reached after considerable discussion. Agreement had also been reached on the issue of registration of acquisition

security rights and the debate should not be reopened.

34. He stressed that the draft Guide was intended to assist legislators in drafting new laws and not to amend existing legislation. The idea was to elaborate the best system conceivable in a transnational context and without reference to any individual State.

35. **Mr. Burman** (United States of America) said that he fully agreed with the representative of France that the purpose of the draft Guide was not to compile an inventory of the various legal systems and economic methodologies that provided for secured interest financing. Its purpose was to provide useful guidance for countries — often developing countries and emerging States — with a special need for economic upgrades. The draft Guide had been elaborated in close collaboration with international financial institutions, all of which agreed that approaches which worked well in the markets of developed countries might not be as effective for the extension of new commercial credit into countries where substantial upgrades in the law were necessary. Moreover, the draft Guide was not a binding instrument. States were free to accept or reject its recommendations, wholly or partially. As the proposal to apply special rules to certain financing instruments would effectively undo the economic advantages offered by the draft Guide, he strongly supported retaining the relevant recommendations in their current form.

36. **Ms. McCreath** (United Kingdom) said that while she understood the point of view of the representatives of France and the United States, she saw no reason why the draft Guide should not describe the different approaches available so that countries could make an informed choice. Any guide’s effectiveness would be measured by the number of countries that eventually made use of it. If the opportunity was not taken to ensure that the draft Guide was as correct as possible, it risked being ineffective and hence ignored.

37. **Mr. Wiegand** (Switzerland) expressed strong support for the statement by the representative of France.

38. **The Chairperson** said that the Commission had mandated a working group some time

previously to prepare a legislative guide which included a public notice filing system or registry. The recommendations in the draft Guide had been approved in principle at the Commission session held in 2006, including the recommendations pertaining to registration and retention of title. While those issues would not be reopened by the Committee, the importance of retention of title to certain delegations had been recognized and an accommodation had been reached in the form of a unitary and a non-unitary approach. She stressed, however, that registration was fundamental to the effective operation of the regime that had been designed.

39. Reverting to recommendation 199, she invited the Committee to consider whether the exception in respect of receivables should be extended to proceeds in the form of negotiable instruments, funds credited in a bank account and obligations to pay under an independent undertaking.

40. **Mr. Wezenbeek** (Observer for the European Union) said that, while he acknowledged the fact that the Committee did not wish to reopen the debate regarding registration and retention of title, he felt it should be stressed that some member States of the European Community still had concerns about recommendation 199, so that the whole package might need to be reassessed if the current wording remained unchanged.

41. **Mr. Smith** (United States of America) said that, as he saw it, the rule in recommendation 199 did not extend the super-priority of the inventory acquisition financier to receivables because those lending against receivables were averse to checking the registry on a regular basis to determine whether the receivable against which they were lending arose from inventory on which there was a super-priority. Moreover, when the receivable was created from the sale of inventory, the receivable financier would lend against the receivable and the proceeds would be used to pay the inventory financier or supplier. There were thus strong policy reasons for the rule and he saw no reason why they should not extend to other payment rights.

42. A receivable financier might not necessarily lend against receivables as strictly defined in the draft Guide. Business people were interested in rights to payment and did not make credit

judgements based on whether a particular receivable matched a definition in the draft Guide. Removing the square brackets and retaining the language it enclosed would be consistent with business concepts of what constituted receivable financing.

43. **The Chairperson** said she took it that the Committee wished to remove the square brackets from recommendation 199 and retain the text they enclosed, and that it requested the Secretariat to reformulate the recommendation along the lines indicated in the note.

44. *It was so decided.*

45. *Recommendation 199, as amended, was adopted.*

B. Non-unitary approach to acquisition financing rights (recommendations 184 to 201)

Recommendations 184 to 190

46. *Recommendations 184 to 190 were adopted.*

Recommendation 191

47. **Mr. Bazinas** (Secretariat) said that recommendation 191 dealt with a conflict of priority between different providers of acquisition financing in the context of the non-unitary approach. It followed the approach taken in systems where retention-of-title sellers or financial lessors had priority as against general secured creditors and stated the principle that suppliers of goods had priority over other acquisition financiers, provided that they had made the right effective against third parties, in accordance with recommendation 189 (b).

48. The note to the Commission following recommendation 191 drew attention to the fact that the latter recommendation was based on the assumption that the draft Guide contained an additional recommendation along the following lines: "The law should provide that, in a non-unitary system, a lender may acquire an acquisition security right or an acquisition financing right through an assignment of the secured obligation from a supplier. If the lender acquires an acquisition security right, the rules applicable to acquisition security rights in a unitary system apply to that acquisition security right. If the lender acquires an acquisition financing right, the rules applicable to

acquisition financing rights in a non-unitary system apply.”

49. The note invited the Commission to consider whether such super-priority of acquisition secured creditors would be compatible with the concept of a non-unitary system. If it was incompatible, recommendation 191 as well as subparagraph (b) of the “Purpose” section should be deleted. If it was compatible, an explicit recommendation such as that just suggested should be added.

50. The note also invited the Commission to consider whether another recommendation enabling suppliers to take an acquisition security right should be included. In such a case, suppliers would be treated in the same way as secured creditors and a non-unitary approach might not be necessary.

51. **Ms. Walsh** (Canada) expressed concern that the terminology used in the non-unitary approach failed to respect the concept of retention-of-title financing and lease financing. In a system that treated retention of ownership as something that was formally distinct from security, priority rules were not expressed in terms of priority rules as such. Rather, priority was effectively obtained because ownership had never passed from the creditor to the buyer. While she appreciated that the intention of recommendation 191 was to bring the consequences of retention-of-title and financial lease security closer to the effective result in a system that adopted a functional approach, the manner in which that purpose had been expressed seemed to eliminate any difference, either in form or in substance, between the unitary and the non-unitary approach. She therefore suggested that the Committee should revert to an approach that respected the form of retained ownership as a basis for third-party effectiveness.

The meeting was suspended at 3.30 p.m. and resumed at 4 p.m.

52. **Mr. Macdonald** (Canada) said that the answers to the questions raised in the note to the Commission would depend on the language used to reflect the Committee’s conceptual framework in the recommendations pertaining to the non-unitary approach.

53. **The Chairperson** asked whether the delegation of Canada was proposing that all the

recommendations in the non-unitary approach section should be redrafted to reflect a property-based terminology.

54. **Ms. Walsh** (Canada) said that in a legal regime in which the concept of security was limited to property owned by the grantor, retention of title under a sale agreement or a financial lease was not a security right. In a retention-of-title transaction, property was owned by the creditor and security was created functionally by not allowing property to pass to the other party to the transaction. Where the seller or lessor entered into competition with a creditor of or a buyer from that other party, it was appropriate to refer to ownership rights rather than to priority because the creditor never ceded ownership and the buyer or lessee was not in a position to transfer ownership of or grant a security right in the property concerned.

55. **Mr. Smith** (United States of America) suggested replacing the term “priority” with “opposability”.

56. If the position of the representative of Canada was that a seller in an ownership regime retained full ownership of an asset so that it was impossible for a buyer to grant any form of security right in the asset, that position ran counter to the policy underlying the draft Guide of enabling credit to be available at cheaper rates. One of the draft Guide’s innovations was its sanctioning of junior security rights as a way in which grantors could obtain credit based on the value of assets. If an ownership regime precluded the buyer from granting a security right, albeit of inferior status to that of the seller, the substantive result would be different from that pertaining to security rights and hence contrary to the policy of the draft Guide.

57. **Mr. Bazinas** (Secretariat) said that the Working Group had discussed at length whether to use opposability or similar notions and had finally decided on “priority”, which was an imperfect solution but the only basis on which agreement could be reached. The Commission had approved the Working Group’s policy decision at its last session.

58. **Mr. Schneider** (Germany) said that he shared the concern of the representatives of Canada that more than a drafting issue was at stake in

recommendation 191, the fundamental problem being that the unitary and non-unitary approaches had essentially the same content.

59. **The Chairperson** pointed out that the text had already been considered by the Working Group and the Commission. Bearing in mind also the time constraints, she urged the Committee to be circumspect in proposing any last-minute changes.

60. **Ms. Kaller** (Austria) expressed support for the point made by the representatives of Canada regarding the terminological problems in the non-unitary approach. Legislators would have difficulty in deciding how to deal with retention-of-title issues and required clear guidance, especially on how to explain the legal situation to industry.

61. **Ms. Gibbons** (United Kingdom) said she shared the concern expressed by the representatives of Canada regarding the treatment of ownership rights and security rights in the draft Guide. It was as though the concept of ownership was being forcibly converted into a concept of security. The Law Commission for England and Wales had recently discussed whether to adopt the North American security model and had decided against doing so largely on account of the recharacterization of ownership rights as security issues.

62. **The Chairperson** urged the Committee to refrain from revisiting decisions that had already been taken by the Working Group with regard to the non-unitary approach. She pointed out that terminological concerns could be adequately dealt with in the commentary.

63. **Mr. Burman** (United States of America) concurred with the Chairperson.

64. **Mr. Umarji** (India) said that, in substance, retention-of-title and loan transactions were both credit transactions whereby funds were provided for the purchase of assets. It had therefore been agreed that the two types of transaction should be held to be equally valid. However, owing to the fact that some jurisdictions had found it difficult to characterize both as secured transactions, it had been decided to provide for a unitary and a non-unitary approach on the understanding that as much equivalence as possible should be sought.

65. He suggested amending the text so that it referred to ownership rights instead of priority. For instance, one could state that the owner of an asset under a retention-of-title arrangement was entitled to retain its ownership rights and retrieve the asset from the buyer.

66. **Mr. Wiegand** (Switzerland) took issue with the charge that property rights were being recharacterized. He pointed out that when an asset was sold through a retention-of-title arrangement, the nature of the property changed by virtue of that transaction and it was a matter of drawing the appropriate consequences rather than recharacterization.

67. **The Chairperson** reiterated her suggestion that the problems raised should be addressed in the commentary.

68. **Mr. Voulgaris** (Greece) expressed support for the Chairperson's suggestion.

69. **The Chairperson** asked whether there was support for the proposals contained in the note following recommendation 191.

70. **Ms. Walsh** (Canada) expressed support for the proposal in the third paragraph of the note, namely that recommendation 191 should be deleted as unnecessary together with subparagraph (b) of the "Purpose" section. The concept of the non-unitary system was based on suppliers retaining ownership as a means of financing acquisitions, and the solution for ordinary secured creditors was to negotiate with any prior secured creditors. Retention of recommendation 191 was incompatible with that concept because it implied that it was possible to have an acquisition security right of the same kind as in the unitary system.

71. **Mr. Cohen** (United States of America) said he was opposed to the deletion of recommendation 191 since it would upset the delicate balance between two parallel systems that had been designed to achieve similar results. Moreover, he did not recall any decision in either the Working Group or the Commission to the effect that in a non-unitary system third-party creditors could not extend acquisition credit and obtain a security right. The deletion of recommendation 191 on the grounds stated by the representative of Canada would

therefore be incompatible with the decisions taken to date.

72. **Mr. Riffard** (France) asked for clarification regarding the types of creditors that would benefit from super-priority.

73. **Mr. Schneider** (Germany) said that there would be no need for super-priority if the proposal by the representative of Canada was adopted, since the seller would remain the owner. If recommendation 191 was retained, it should remain in its current form and the seller should enjoy super-priority.

74. **Ms. Walsh** (Canada) said that there were a number of different financing scenarios for acquisition security. A jurisdiction that wished to adopt the unitary approach could achieve the same substantive results for sellers, financial lessors and institutional lenders through a functional concept of security. In that case, a recommendation such as 191 was necessary because there were different categories of creditors who would have security as between suppliers and lenders.

75. The non-unitary approach was presented in the draft Guide as an alternative to the unitary approach. However, if the logic of retention of title or leasing was retained, while at the same time provision was made for an acquisition security right with super-priority, the non-unitary approach would merely supplement the unitary approach.

76. If the non-unitary approach was treated as an alternative to the unitary approach, the substantive results of the two approaches were broadly the same. There were two ways in which a lender could contribute to acquisition secured financing. It could take an assignment of the supplier's right in return for paying out the supplier, thereby acquiring super-priority through assignment of the title enjoyed by the retention-of-title seller. Alternatively, a lender could take security in the buyer's right under the retention-of-title sale so as to claim ownership under that sale upon satisfaction of the purchase price. In so doing, the lender would acquire the residual value after the seller had been paid. As the lender was taking only an ordinary security right, it would rank second in priority to the seller, who retained ownership and thereby had first claim. Thus, the final result was the same: the supplier ranked ahead of the acquisition lender. Both scenarios were unproblematic, unlike the current approach, which combined a concept of acquisition security rights for lenders with a concept of retention of title and financial lease for suppliers.

77. **Mr. Voulgaris** (Greece) said that there could be no super-priority in the case of retention-of-title or financial lease arrangements, since super-priority presupposed full ownership.

The meeting rose at 5 p.m.

**Summary record of the 840th meeting, held at the Vienna International Centre
on Wednesday, 27 June 2007, at 9.30 a.m.**

[A/CN.9/SR.840]

Chairman: Ms. Sabo (Chairperson of the Committee of the Whole) (Canada)

The meeting was called to order at 9.45 a.m.

**Adoption of a draft UNCITRAL Legislative Guide
on Secured Transactions and possible future work
(continued)** (A/CN.9/617, 620, 631 and Add.1-11,
632 and 633)

XII: Acquisition financing rights (continued)
(A/CN.9/631 and Add.9)

*B. Non-unitary approach to acquisition financing
rights (continued) (recommendations 184 to 201)*

1. **The Chairperson** noted that some delegations had voiced concern that the absence of references to property-based concepts made the recommendations on the non-unitary approach to acquisition financing rights less accessible to the reader. She invited members to suggest possible courses of action to resolve the matter promptly and effectively.

2. **Mr. Riffard** (France) said that it had emerged from informal consultations that greater clarity could be achieved through redrafting. However, it would first be necessary to decide whether it was wise to use the concept of priority in the non-unitary approach.

3. Consensus had been achieved on the purpose of acquisition financing rights, namely to confer preferential status on the acquisition financier. In the context of the unitary approach, which treated all secured creditors equally, the objective of conferring such status could be achieved only by proposing that the lawmaker should accord super-priority to acquisition financiers. In the context of the non-unitary approach, preferential status resulted simply from the acquisition financier's retention of title to the asset. An acquisition financier in a non-unitary system must thus acquire a security right giving it a right to the title either through a retention-of-title clause or indirectly through the assignment of a receivable with a security right attached.

4. The sole remaining stumbling-block was whether, in the context of the non-unitary system, a secured lender that financed the acquisition of tangible property should be accorded preferential status. If so, it would be necessary to introduce the concept of priority into the non-unitary approach. There would then be two categories of acquisition financiers with preferential status, those who derived that status from their retention of title and those who had been given super-priority, and it would be necessary to determine how conflicts between them should be settled.

5. He proposed that the recommendations should be redrafted without changing the substance as soon as the Committee reached agreement in principle.

6. **Mr. Voulgaris** (Greece) said that another pending issue was the formalities to be completed in order to establish third-party effectiveness in the case of retention-of-title transactions, which should be registered in the same way as other security rights. The principle was laid down in recommendation 186 in the unitary approach section.

7. **Mr. Macdonald** (Canada) said that some of the language used in the draft Guide might lack transparency for first-time users, who might be confused to find that rules apparently governing security rights were equally applicable to retention-of-title rights. The recommendations should therefore be elaborated to make it clear how they were to be applied in an ownership regime and in a security rights regime and how the principle of functional equivalence was to be upheld. He therefore strongly supported the proposal made by the representative of France.

8. **Mr. Burman** (United States of America) said that he also supported that proposal.

9. **Mr. Voulgaris** (Greece) expressed support for the proposal provided that the substance of recommendation 189 (a) and (b) was retained.

10. **The Chairperson** said she took it that the Committee wished to redraft the recommendations concerning acquisition financing rights in the non-unitary approach section.

11. *It was so decided.*

Recommendation 191 (continued)

12. **Mr. Macdonald** (Canada) said that the idea expressed in the second paragraph of the note to the Commission following recommendation 191 should be reflected in the non-unitary approach section of the draft Guide so that readers understood how the principle of equivalence should be applied in practice.

13. **Mr. Burman** (United States of America) said that it was unclear why a third-party acquisition financier should be limited to acquiring an acquisition security right or an acquisition financing right through assignment. One of the benefits of creating the notion of a third-party acquisition financier was to give buyers a competitive choice, i.e. either to borrow money from a bank or obtain credit from the seller. Restricting the third-party financier's possibilities in the aforementioned manner precluded competition and placed sellers in a position where they could request a share in the interest chargeable by the bank, because they would be able to withhold the assignment.

14. Furthermore, the scope of application of recommendation 191 would be relatively limited, since it would involve concurrent acquisition financing from a third party and a seller. Moreover, such a rule, while acceptable, would tend to favour the seller.

15. **Mr. Macdonald** (Canada) said that the second paragraph of the note to the Commission clearly stated that lenders were free to acquire either an acquisition security right or an acquisition financing right, the latter through an assignment from the seller. Lenders could thus avail themselves of the full range of options and he had not intended to suggest that they should be barred from acquiring acquisition security rights.

16. **Mr. Kohn** (Observer for the Commercial Finance Association) cautioned the Committee against deleting subparagraph (b) of the "Purpose" section, as suggested in the third paragraph of the

note to the Commission. The subparagraph stated the key concept of functional equivalence and should be retained irrespective of any redrafting of recommendation 191.

17. **The Chairperson** said she took it that the Committee was satisfied with the policy expressed in recommendation 191 and supported the inclusion of the second paragraph of the note to the Commission, on the understanding that lenders would have the full range of options at their disposal.

18. *It was so decided.*

19. *Recommendation 191 was adopted on that understanding.*

Recommendation 192

20. **Mr. Kemper** (Germany) said that the additional requirements imposed by recommendation 192 on an acquisition financier, particularly a retention-of-title seller, were unjustified if the goods constituted inventory for the buyer. Such cases should be dealt with according to the rule set out in recommendation 189 for tangible property other than inventory or consumer goods.

21. **The Chairperson** said that paragraphs 114 to 118 of the commentary to chapter XII might require further elaboration since they failed to explain adequately the reasoning behind the different treatment accorded to tangible property and inventory.

22. **Mr. Schneider** (Germany) asked whether the term "inventory" was to be defined from the seller's or the buyer's perspective. Tangibles might constitute inventory for the seller but not for the buyer, or vice versa. The delegation of the United States might be able to provide some enlightenment on that point, since the recommendation appeared to be based on article 9 of the United States Uniform Commercial Code. He would also appreciate an explanation of how a seller was supposed to establish whether any earlier-registered non-acquisition security right existed in the buyer's country. The seller would have to inspect the country's registry, probably with the assistance of a lawyer, and then notify the holder of the earlier-registered acquisition security right, all of which would delay delivery of the goods.

23. **Mr. Cohen** (United States of America) noted that the term “inventory” was used extensively throughout the draft Guide. Recommendation 87 in chapter VII on priorities, for example, stated that a buyer of inventory in the ordinary course of the seller’s business took free of the security right. He agreed with the representative of Germany that problems might arise where goods constituted inventory in the hands of the seller but equipment in the hands of the buyer. In the case of recommendation 87, the commentary and the terminology guide in document A/CN.9/631/Add.1 made it clear how the term inventory was to be interpreted. The same approach could be adopted in the case of recommendation 192.

24. Problems pertaining to international sales of goods, international acquisition finance and conflict-of-law situations also arose throughout the draft Guide. Those difficulties should not prevent the Commission from recommending rules that were appropriate for domestic transactions, and as more and more States followed those rules, the problems arising in an international context should diminish.

25. **Mr. Kemper** (Germany) said that the draft Guide was intended for States wishing to enact legislation that covered both domestic trade and international trade transactions involving, for example, imports of goods under retention-of-title arrangements. Such legislation would also spell out the requirements for obtaining priority through registration. However, he considered that the policy choice made in recommendation 192 was unsound. As currently worded, it favoured financial institutions to the detriment of retention-of-title sellers. The latter needed a reasonable and uncomplicated registration system to ensure speedy trade transactions.

26. **Mr. Mitrović** (Serbia) said that if the recommendations in the draft Guide were modelled on existing national legislation, as in the example cited by Germany, the commentary might usefully include a cross-reference to that legislation.

27. **Mr. Sigman** (United States of America) said that the draft Guide was not based on policy choices but on economic efficiency. It did not focus on exporters or importers but on the buyer as debtor. For instance, where a buyer purchased machinery from suppliers in six different countries, the

six sellers that exported their goods would be competing in the event of the buyer’s insolvency with the buyer’s other creditors. The draft Guide, by advocating a modern efficient electronic registry, should speed up trade dramatically because the seller would be able to access information about the registry in the buyer’s country in order to determine where it must register and who prior registrants were.

28. **Mr. Kemper** (Germany) said that by policy choice he had meant the choice of a legislator who had to balance policies and interests. It was not merely a technical issue.

29. **Mr. Bazinas** (Secretariat) said he gathered that the main objection to recommendation 192 was that it seemed to make a policy choice in favour of general financiers to the detriment of sellers of goods on credit with retention of title because of the registration and notification requirements. However, in recommendation 191 sellers were accorded priority over general financiers, a situation that reflected to some extent the current practice in countries where retention of title was the main non-possessory security interest.

30. Although registration would be required, the burden on the supplier would depend on the registry concerned. If it was well organized, registration could be speedy and inexpensive and notification could be provided for all transactions likely to take place over a period of years.

31. With regard to international trade, sellers that sold goods subject to retention of title to buyers in countries where retention-of-title rights were currently not recognized would be comforted to know that, once legislation modelled on the draft Guide had been enacted in the country of destination of the goods, the retention-of-title seller would have a security right and would be recognized in the event of insolvency provided that the necessary steps for third-party effectiveness had been taken.

32. **Mr. Schneider** (Germany) said that the first important issue to address was how to define inventory. He welcomed the implication in an earlier statement by a representative of the United States that inventory should be defined from the point of view of the seller and not of the buyer since inventory could be equipment in the hands of the

buyer. He proposed that the commentary should reflect such a definition. While he understood why notification should be provided to an inventory financier, he saw no reason why a financier of equipment should expect to receive notification.

33. Under recommendation 192, while the seller could retain ownership, such retention was being made unnecessarily difficult and fast delivery was being impeded by the registration and notification requirements. While his delegation had come to accept the need for registration, it still saw no need for notification.

34. **Mr. Kemper** (Germany) said that the draft Guide was becoming increasingly sophisticated and lengthy. He therefore proposed merging recommendations 189 and 192 so that one rule along the lines of recommendation 189 would apply to both inventory and tangible property other than inventory.

35. **Mr. Kohn** (Observer for the Commercial Finance Association) said that one of the virtues of the non-unitary approach section was that it protected all the parties and provided a simple way for the seller of goods to acquire super-priority. Sellers already had to understand import and export laws, to make credit decisions regarding buyers and to perform other due diligence activities when making a sale, especially to a buyer in another country. While it was true that additional registration and notification were required under the non-unitary approach, they were essentially simple administrative acts that would not slow down the process. Another virtue of the approach was that existing inventory financiers would be protected, since they would be notified in cases where they were financing inventory subject to a prior super-priority claim. Although the terminology section of the draft Guide defined inventory in terms of property held in the ordinary course of the grantor's business, it should be a simple matter for the seller to determine the facts as part of its due diligence when making a decision to sell goods to a particular buyer.

36. **The Chairperson** noted the concerns expressed by the representatives of Germany regarding recommendation 192 and suggested that its proposal should be reflected in the commentary so that legislators were at least aware of it.

37. **Mr. Kemper** (Germany) said that a legislative guide was normally less stringent than a model law and he felt that the draft Guide should offer more options to legislators. He therefore proposed presenting two options with respect to the current issue: the first option would be to maintain differential treatment for inventory and tangible property other than inventory, along the lines of recommendations 189 and 192; the second option would be to treat both in the same way, along the lines of recommendation 189. In the latter case, recommendation 192 would be deleted and the commentary would explain the choices proposed in recommendation 189. He added that his proposal also applied to the unitary approach section.

The meeting was suspended at 11.15 a.m. and resumed at 11.45 a.m.

38. **Mr. Ghia** (Italy) expressed support for the proposed optional approach since it offered more flexibility.

39. **Ms. McCreath** (United Kingdom) said that, as far as she was aware, the electronic registration system mentioned by a representative of the United States was not yet available throughout Europe and was unlikely to be available to speed up registration for some time.

40. She expressed support for the flexible option proposed by the representative of Germany.

41. **Ms. Kaller** (Austria), **Mr. Bellenger** (France), **Ms. Kolibabska** (Poland), **Mr. Voulgaris** (Greece) and **Mr. Brink** (Observer for Europafactoring) also expressed support for the proposal.

42. **Mr. Smith** (United States of America) said that he wished to defer a decision on the proposal until all the recommendations in the non-unitary section had been discussed, since the proposal needed to be considered in the light of the entire chapter.

43. **Mr. Patch** (Australia) said that the Commission needed to show leadership to jurisdictions that were contemplating implementing the draft Guide and should therefore leave no doubt or ambiguity as to the preferred course of action. Thus, while the draft Guide should express a view, the commentary could forcefully put forward the alternatives.

44. **Mr. Umarji** (India) said that under normal circumstances, even without registration, disclosure by the grantor was required in a retention-of-title transaction where third-party rights were being created. The registration requirement would merely serve as an additional guarantee.

45. **Mr. Kohn** (Observer for the Commercial Finance Association) drew attention to the economic consequences of any decision to move from the current balanced approach that protected all parties to an approach that favoured the seller to the detriment of the inventory financier. Should such a decision be taken, it would be important for the commentary to explain the economic consequences, which would include a widespread contraction of credit.

46. **Mr. Kemper** (Germany) said that if the proposed option was adopted, the commentary would take such consequences into account. However, it would not state that the option to merge the two recommendations into recommendation 189 favoured the seller and that the other option represented a balanced approach.

47. **The Chairperson** agreed that the commentary should instruct the legislator to consider the economic consequences arising from either option and that it should also address considerations pertaining to the efficiency of the registry. While she had noted the request by the representative of the United States to defer a decision, she gathered from the strong support expressed by a number of speakers that the Committee wished to offer an alternative approach to recommendations 189 and 192 in both the unitary and the non-unitary sections. Under that approach, a new recommendation along the lines of recommendation 189 would address the priority position applicable to an acquisition security right or an acquisition financing right in tangible property.

48. *It was so decided.*

Recommendation 193

49. *Recommendation 193 was adopted.*

Recommendation 194

50. **Ms. Stanivuković** (Serbia) noted that in recommendation 194 the word “right” had been

omitted after the word “financing” in the fourth line of the English version. Moreover, recommendation 194 (a) was confusing because it seemed to refer to a judgement obtained after a security right was created but before it was made effective against third parties.

51. **The Chairperson** said she took it that the Committee wished to clarify the wording of the recommendation.

52. *It was so decided.*

53. *Recommendation 194 was adopted on that understanding.*

Recommendations 195 to 197

54. *Recommendations 195 to 197 were adopted.*

Recommendations 198 and 199

55. **Mr. Smith** (United States of America) asked whether the alternative approach adopted to recommendations 189 and 192 had implications for recommendations 198 and 199, which dealt, respectively, with proceeds of tangible property other than inventory or consumer goods and proceeds of inventory.

56. **Mr. Kohn** (Observer for the Commercial Finance Association) said that the representative of the United States had raised a pertinent issue, since the Committee’s decision regarding recommendations 189 and 192 would, in his view, reduce the credit provided by inventory financiers. He cautioned against taking a further decision that would have an impact on the credit available from receivables financiers.

57. **Mr. Schneider** (Germany) said that if the second option — involving the merger of recommendations 189 and 192 — was adopted, recommendation 199 would become irrelevant and should be deleted.

58. **Mr. Bazinas** (Secretariat) said that, although many legal systems followed the approach set out in the second option with regard to goods that were subject to retention of title, very few extended priority to the proceeds of goods. Moreover, in some of the latter jurisdictions priority was lost if the proceeds were commingled and no longer identifiable.

59. **Mr. Smith** (United States of America) said that, in his view, recommendation 199 set forth a strong policy of encouraging receivables financing arising from the sale of inventory, because receivables financiers would not have to check the registry constantly. Whatever the fate of recommendations 189 and 192, recommendation 199 should stand on its own as the sole recommendation for dealing with super-priority on proceeds relating to sales of inventory.

60. **Mr. Weise** (Observer for the American Bar Association) said that the Committee's previous decision on whether notice should be given to the inventory-secured lender, which related to the convenience of the seller, had no bearing on the present issue, which related to the financing of the buyer's receivables. If recommendations 189 and 192 were merged, there was nothing to prevent recommendation 198 from being deleted and recommendation 199 becoming the general rule, although he would not necessarily advocate such an approach.

61. **Mr. Schneider** (Germany) said that he had been hesitant about the notification requirement from the outset and the problem would be compounded if it were extended to recommendation 199. Assuming that the second option was adopted, it would be preferable to retain recommendation 198 and delete recommendation 199. The Secretariat had rightly noted that different jurisdictions had different rules regarding proceeds, but proceeds were in all cases substitutes for goods delivered and retention of title should therefore continue.

62. **Mr. Kohn** (Observer for the Commercial Finance Association) said that the notion of extended retention of title, as reflected in recommendation 198, existed, as far as he knew, in only one jurisdiction. It should not therefore be proposed as an option in the draft Guide without very serious consideration. The Working Group had drafted recommendation 199 after lengthy deliberation to provide balance and to maximize the amount of credit available by encouraging both receivables finance and inventory finance. Adoption of recommendation 198, by contrast, would discourage receivables finance. Even presenting it as an option would send out the wrong message, since the purpose of the draft Guide was to promote

credit by encouraging certainty for lenders. Recommendation 199 provided that kind of certainty for both acquisition and receivables financiers.

63. **Mr. Smith** (United States of America) concurred. With regard to the question of whether notification was required for proceeds, he had understood that, under the alternative approach, the seller would have obtained priority as to the goods and would be given a grace period for registration. If super-priority extended to the proceeds, however, as envisaged under recommendation 198, the draft Guide's encouragement of receivables financing would be seriously undermined and the seller's rights would exceed those existing in most jurisdictions, in which the seller's retention-of-title rights did not extend to proceeds. The deletion of recommendation 199 would seriously undermine the balance achieved by the compromise agreement reached earlier in the meeting.

64. **Mr. Wezenbeek** (Observer for the European Union) said that it was clear from discussions among member States of the European Union that the observer for the Commercial Finance Association had been wrong to imply that Germany was the only country that wished to retain the provision contained in recommendation 198. On the contrary, the provision had relatively wide support and should be accommodated in the draft Guide. He added that he was not fully convinced that registration was the ideal system.

65. **Mr. Burman** (United States of America) expressed concern that issues previously resolved by the Working Group and the Commission were being raised again at every meeting. If there was a substantial level of support for a given change, his delegation would accept it. In the case of recommendations 189 and 192, for instance, although it had doubted the strength of support for a change of policy, it had raised no objection in a spirit of compromise. However, it would strongly oppose the continued reconsideration of points on which agreement had already been reached.

66. **Mr. Kemper** (Germany) said that he had no specific proposal to amend either recommendation 198 or recommendation 199. He simply wished to draw attention to the implications, especially for recommendation 198 which echoed the wording of

recommendation 189, of the adoption of the second option.

67. **The Chairperson** said that a distinction should be made between drafting changes and policy changes. The decision on the two options would entail drafting changes to recommendations 198 and 199.

68. **Mr. Bazinas** (Secretariat) assured the Committee that recommendations 198 and 199 would be reformulated to take into account the changes that had been agreed.

The meeting rose at 12.30 p.m.

**Summary record of the 841st meeting, held at the Vienna International Centre
on Wednesday, 27 June 2007, at 2 p.m.**

[A/CN.9/SR.841]

Chairman: Ms. Sabo (Chairperson of the Committee of the Whole) (Canada)

The meeting was called to order at 2 p.m.

Adoption of a draft UNCITRAL Legislative Guide on Secured Transactions and possible future work (continued) (A/CN.9/617, 620, 631 and Add.1-11, 632 and 633)

XII: Acquisition financing rights (continued)
(A/CN.9/631 and Add.9)

Non-unitary approach to acquisition financing rights (continued) (recommendations 184 to 201)

Recommendations 198 and 199

1. **The Chairperson** said that, if she heard no objection, she would take it that the Committee agreed on the substance of recommendations 198 and 199 and would leave it to the Secretariat to make the necessary editorial changes. She also took it that the Committee wished to remove the square brackets from recommendation 199 and to retain the text they enclosed, as had been done in the case of recommendation 199 in the unitary approach section.

2. *Recommendations 198 and 199 were adopted on that understanding.*

Recommendations 200 and 201

3. *Recommendations 200 and 201 were adopted.*

Commentary to chapter XII: Acquisition financing rights (A/CN.9/631/Add.9)

4. **The Chairperson** said she took it that the Committee wished to approve the substance of the commentary to chapter XII, subject to any changes required to reflect the amendments to recommendations 184 to 201 (unitary and non-unitary approaches).

5. *The substance of the commentary to chapter XII was adopted on that understanding.*

XIII: Private international law (A/CN.9/631 and Add.10)

6. **Mr. Deschamps** (Canada), supported by **Mr. Voulgaris** (Greece) and **Mr. Riffard** (France), said that he was not convinced of the wisdom of changing the title of the chapter from “Conflicts of laws” to “Private international law”. While conflict-of-law rules certainly formed part of private international law, chapter XIII dealt exclusively with the rules governing the law applicable to security rights. The scope of private international law was far broader and included rules that were unrelated to conflict-of-law issues, such as the jurisdiction of courts and the recognition and enforcement of foreign judgements. It would therefore be preferable to retain the heading used in the past.

7. **Mr. Marca Paco** (Bolivia) said that neither the title “Private international law” nor the title “Conflicts of laws” was appropriate. The purpose of the chapter was to determine the applicable law, regardless of whether a conflict of law existed. The most appropriate title would therefore be “Applicable law”.

8. **The Chairperson** said she took it that the Committee wished to replace the title “Private international law” by a more appropriate title, leaving the choice of the most suitable title for each language version to the terminology specialists.

9. *It was so decided.*

10. **Mr. Wezenbeek** (Observer for the European Union) suggested deleting the footnote referring to cooperation with the Hague Conference on Private International Law, which seemed inappropriate.

11. **The Chairperson** said that cooperation with the Permanent Bureau of the Hague Conference was an example of inter-agency cooperation that the Working Group felt should be encouraged by acknowledging it in a footnote.

12. **Mr. Kemper** (Germany) suggested inserting the words “Permanent Bureau of” before “the Hague Conference on Private International Law”.

13. *It was so agreed.*

Recommendation 202

14. **The Chairperson** asked whether the Committee wished to include the text currently in square brackets in recommendation 202.

15. **Ms. Okino Nakashima** (Japan) proposed including the text. In cases where movable assets were subject to a specialized registration system, the law of the State under the authority of which the registry was maintained should prevail.

16. **Mr. Voulgaris** (Greece), **Mr. Sigman** (United States of America) and **Ms. McCreath** (United Kingdom) concurred.

17. **Mr. Wezenbeek** (Observer for the European Union) said that the subject matter of chapter XIII was highly controversial. The Convention on the Law Applicable to Certain Rights in respect of Securities Held with an Intermediary (the Hague Securities Convention) had been adopted quite speedily in 2002 but so far only two States had signed it. Opinions within Europe were deeply divided on whether or not to sign. A proposed regulation on the law applicable to contractual arrangements (Rome I), which contained provisions on assignments of receivables and conflicts of law, was also currently the subject of heated debate in the European Union. Chapter XIII was a crucial component of the draft Guide and, given the complexity of the underlying issues, should not be adopted hastily.

18. **The Chairperson** noted that the rule contained in recommendation 202 was consistent with the United Nations Convention on the Assignment of Receivables in International Trade (United Nations Assignment Convention). The European Commission had in the past stated its willingness to work towards a solution that would be consistent with that instrument so that European Union member States could adopt it.

19. **Mr. Rögner** (Observer for the European Insurance and Reinsurance Federation) expressed support for the comments made by the observer for

the European Commission and for the inclusion of the text in square brackets, which explained why *lex situs* should be the applicable law.

20. **Mr. Marca Paco** (Bolivia) asked whether the proposal contained in the note to the Commission had been inserted on the assumption that the text in square brackets would be retained as part of recommendation 202. The question of whether the text was included would, in his view, influence the Committee’s decision on whether to add a recommendation in the light of the note.

21. **Mr. Bazinas** (Secretariat) said that the note had not been intended to prejudge the Committee’s decision on the text in square brackets.

22. **The Chairperson** said she took it that the Committee wished to include the text in square brackets in recommendation 202.

23. *It was so decided.*

24. *Recommendation 202, as amended, was adopted.*

25. **The Chairperson** invited the Committee to consider the proposal contained in the note to the Commission following recommendation 202.

26. **Mr. Bazinas** (Secretariat) said that the Commission was invited to consider whether it wished to include a recommendation that would address the priority conflict between two creditors, one with a possessory security right in a negotiable document and the other with a non-possessory security right in the goods covered by the document. The recommendation would state explicitly, in line with current practice, that the law of the location of the document should apply in order to preserve the negotiability of the negotiable document. The matter could be clarified in the commentary to chapter XIII but the Committee might wish to address it in a separate recommendation.

27. **Mr. Deschamps** (Canada) expressed support in principle for the addition of a recommendation. However, it might be best to defer a decision on the matter pending the outcome of the discussion of the revised version of recommendation 107, which concerned the question of whether a secured creditor that held a bill of lading had priority as against a competing claimant that held a right in the goods under another mechanism.

28. **Mr. Pendón Meléndez** (Spain) reiterated his dissatisfaction with the draft Guide's approach to negotiable instruments. Before acting on the note to the Commission, the Committee should take a clear-cut decision on recommendation 107. He therefore endorsed the proposal made by the representative of Canada.

29. **Mr. Bazinas** (Secretariat) said that the Committee might also wish to consider situations in which there was a conflict of priority between a security right in a negotiable document and a security right in the goods covered by the document, where the latter security right was subject to a specialized registration system. While he considered that the law of the location of the negotiable document should be applicable, the Committee might wish to discuss the matter in the light of the revised version of recommendation 107.

30. **The Chairperson** said she took it that the Committee wished to defer a decision regarding the note to the Commission until it had an opportunity to discuss the revised version of recommendation 107.

31. *It was so decided.*

Recommendation 203

32. **Mr. Pendón Meléndez** (Spain) said he took it that recommendation 203 applied only to tangible property in transit for which no negotiable instrument or negotiable document had been issued. If so, there should be a reference to that exclusion in the commentary to chapter XIII.

33. **Mr. Bazinas** (Secretariat) said that recommendation 203 applied irrespective of whether the goods were covered by a negotiable document or whether the document travelled with the goods. The reference to tangible property other than negotiable instruments or negotiable documents referred to the goods only and had no bearing on the issue of whether a negotiable document existed.

34. **Mr. Voulgaris** (Greece) said he agreed that goods in transit should be considered separately from the documents by which they might be covered. The recommendation should further specify that the transit must be completed within seven days.

35. **Mr. Pendón Meléndez** (Spain) said that, since the issue was related to the general regime applicable to negotiable documents and affected other recommendations, it would be useful to include a general explanatory note in the commentary. There was a general unwritten rule in international transport that, once tangible property in transit was covered by a negotiable document, any action affecting the property, for example the exercise of security rights, must be taken on the basis of the negotiable document.

36. **Mr. Voulgaris** (Greece) called for a substantive discussion of the matter. If, for example, a bill of lading had been issued in respect of goods in transit, the law governing bills of lading should clearly be applied.

37. **The Chairperson** suggested that the issue should be addressed once a decision had been taken on recommendation 107 and on the note following recommendation 202.

38. *It was so decided.*

39. **Mr. Riffard** (France) said that the question of the applicable law in the case of transfer of a security right by way of assignment of a receivable had not been resolved. He proposed inserting a recommendation to address that question, which had major practical implications.

40. **The Chairperson** expressed the view that the relevant rule in the United Nations Assignment Convention should apply.

41. **Mr. Deschamps** (Canada) said that it could be inferred from article 22 of the Assignment Convention concerning the law applicable to competing rights that the law governing priority would determine whether the assignee was entitled to benefit from the security right in a receivable. The implicit rule was that the law of the grantor would determine whether formalities were required to enable the assignee to benefit from the security right in the receivable. However, the issue was complex and required further in-depth consideration.

42. **The Chairperson** suggested deferring consideration of the issue and of recommendation 203 until all the recommendations in chapter XIII had been considered.

43. *It was so decided.*

Recommendation 204

44. **Ms. Perkins** (United Kingdom) said that recommendation 204 was an inappropriate rule for intangible property, which was the currency of the financial markets. Under certain circumstances, the recommendation would give rise to irreconcilable ambiguities for the forum court, and uncertainty was the very thing that the Commission was seeking to eliminate. Some delegations considered that the practical advantages of recommendation 204 for regular transactions involving the bulk assignment of receivables or the assignment of future receivables outweighed the disadvantages of uncertainty in respect of irregular transactions. However, it could be inferred from the comprehensive carve-out in the Assignment Convention for financial contracts and financial instruments, i.e. other intangibles, that recommendation 204 did not work for situations other than the bulk assignment of receivables or the assignment of future receivables.

45. By way of illustration, she described a situation in which an assignor granted a first security interest (interest A) in one location and then moved location and, retaining possession, granted a second security interest (interest B) in the second location. The forum court could then be faced with a situation in which either both interests or neither interest had priority. If, for example, interest A in the intangible had been created first but registered second and interest B had been created second but registered first, and if the law of the first location provided that priority was determined by the date of creation and the law of the second location provided that priority was determined by the date of registration, both security interests would take priority over one another under recommendation 204.

46. Similarly, if an assignment of a letter of credit by the assignor for security purposes in one location was followed by a reassignment by the assignee from a different location, and notice to the issuing bank was not required by the law of the first location in order to acquire priority but was required by the law of the second location, the forum court would again be faced with a situation in which both interests had priority. It followed that

recommendation 204 was inappropriate, possibly in all cases but certainly for intangibles other than the bulk assignment of receivables and the assignment of future receivables.

47. **Mr. Deschamps** (Canada) said that situations such as those just described potentially arose not only in respect of financial contracts but also in respect of other kinds of intangible property or trade receivables. If an assignor located in one State granted an assignment to a first secured creditor, and the assignor's chief place of business was subsequently moved to a second State from which the assignor granted an assignment to a second secured creditor in respect of the same receivable, letter of credit or financial contract, it was unclear which law should apply to the competing claims of the two secured creditors, especially if the law of the first State gave priority to the first creditor and the law of the second State to the second creditor. He submitted that the solution lay in recommendation 216, according to which, in the situations described by the representative of the United Kingdom, the law of the new location of the grantor would determine priority as between competing claimants.

48. **Mr. Bazinas** (Secretariat) said that the draft Guide treated assignments from assignor A to assignee B in different countries that were subsequently assigned to assignee C on the basis of the Assignment Convention as subsequent assignments that did not create a priority conflict because the first assignee took the position of the assignor. It was thus not a matter of competing claims giving rise to a conflict of priority.

The meeting was suspended at 3.35 p.m. and resumed at 4.05 p.m.

49. **Ms. Perkins** (United Kingdom) said that, while recommendation 216 might settle matters for the forum court, it did so in a manner that was largely arbitrary as between the assignees of the first and second security interests. In situations where there were competing assignments and the priority rules were different in the two locations of the assignments, the forum court was required to apply the priority rules of the second location. Such a rule was disadvantageous for the first assignee who could not be sure that it was guaranteed priority at the time the security interest was granted, since future

changes in the location of the grantor might affect the priority and effectiveness of its security interest vis-à-vis future assignees. Hence, recommendation 216 did not provide an adequate solution to the issues arising from recommendation 204.

50. Her objection to recommendation 204 would perhaps have been better phrased as a concern about the position of the debtor, who was often a financial markets debtor, rather than about the dilemma for the forum court. Where a security interest was created in a financial contract, it was important for the debtor under that contract, who could be an out-of-money party under a derivatives or foreign exchange contract or the issuer of a letter of credit, to know whom to pay if the debt was assigned. If the law governing those issues was identified according to the location of the grantor or assignor and that location was subject to change, the financial markets debtor would be unable to identify with any certainty the law applicable to priority questions and vis-à-vis new assignees.

51. **Mr. Bazinas** (Secretariat) said that recommendation 216, which provided that the relevant location was that of the grantor at the time the priority conflict arose, might create the impression that the assignee in the original location would automatically lose priority. However, under recommendation 46 the assignee in the initial location could preserve its third-party effectiveness and priority by meeting the requirements for third-party effectiveness of the new location within a grace period. A separate rule contained in recommendation 208 governed the creation, third-party effectiveness, priority, enforcement and rights and obligations of the issuer of a letter of credit.

52. **Ms. Kaller** (Austria) said that she agreed with the comment of the representative of the European Commission on the complexity of the issues addressed in chapter XIII, which had been discussed in a number of forums. While she was uneasy about its inclusion in the draft Guide, she respected the fact that decisions had already been taken, inter alia in the context of the United Nations Assignment Convention, which could not easily be reversed. However, the solution provided in recommendation 204 was unsatisfactory. In the context of the European Commission proposal for a regulation of the European Parliament and the

Council on the law applicable to contractual obligations (Rome I), the law of the assignor's location and the law governing the assigned receivable were being discussed as the options for the law applicable to third-party effects of assignments.

53. **Mr. Ghia** (Italy) endorsed the statements by the representatives of the United Kingdom and Austria. He expressed a preference for the application of the *lex contractus* chosen by the parties.

54. **Ms. Walsh** (Canada) said that recommendation 213 addressed the concern raised by the representative of the United Kingdom regarding the need for a debtor to know whom it must pay so as to be discharged from its obligation. The recommendation confirmed that the applicable law was that governing the payment obligation, in other words the contract that gave rise to the obligation that had been the subject of an assignment or the creation of a security right. Whether the person entitled to payment was also entitled to priority was a matter to be agreed among the competing assignees or secured creditors. Account debtors that fulfilled their payment obligations in accordance with the law governing the contract out of which the obligation arose were always protected. That law also governed the existence and extent of any right of set-off.

55. **Mr. Weise** (Observer for the American Bar Association) said that it should be borne in mind that the choice of applicable law also governed effectiveness against third parties. If the law that governed the receivable also governed third-party effectiveness, there would potentially be multiple registrations in multiple States. It should also be borne in mind that rules concerning applicable law were generally based on the assumption that other States had comparable laws, so that the hypothetical situation described by the representative of the United Kingdom in which effectiveness against third parties occurred upon creation would rarely arise.

56. **Mr. Murray** (United Kingdom) said that the structure of the draft Guide, which required legislators to refer to recommendations 204, 216 and 46 when addressing the issue under discussion, was inconvenient. Moreover, recommendation 46 appeared to require a vigilance on the part of the

assignee that was inconsistent with financial-market expectations.

57. While recommendation 213 stated the formal position with regard to debtor protection, debtors of financial claims were frequently not indifferent as to whether the ultimate owner of the debt was their relationship bank or a vulture fund. They usually wished to be certain that the law which they had agreed should govern the debt they owed would also determine the question of the assignability of a claim.

58. **The Chairperson** reminded the Committee that the pending debate on financial contracts might help to resolve some of the issues raised. She did not see any justification in the light of the discussion for amending recommendation 204.

59. **Ms. McCreath** (United Kingdom) reiterated her delegation's serious concern about recommendation 204, which she felt was shared by several other delegations. She proposed deferring a final decision on the recommendation until after the discussion of financial contracts.

60. **Mr. Kemper** (Germany) expressed support for that proposal.

61. **Mr. Deschamps** (Canada), referring to the question of the debtor of a receivable under a financial contract that was opposed to having payment obligations to a vulture fund, said that the issue of whether the receivable was assignable was addressed in recommendation 213 (b). If the contract giving rise to the receivable contained an anti-assignment clause, and if that clause was valid under the law governing the contract, the clause would be effective unless the receivable was a trade receivable.

62. **Mr. Burman** (United States of America) expressed strong support for the wording of recommendation 204. He was unwilling to engage in any further discussion of the matter.

63. **The Chairperson** said that the Working Group had discussed the question at length and that the Commission had taken a decision. Despite the concerns expressed by some delegations, there did not seem to be majority support for reopening the debate on the substance of recommendation 204. Moreover, she trusted that the discussion of

financial contracts would allay any remaining concerns.

64. **Ms. McCreath** (United Kingdom) said she disagreed with that conclusion. A number of delegations had expressed valid concerns. Once adopted, the draft Guide would be held to represent best practice and if there were already real doubts about the applicability of certain recommendations, further discussion was essential. It was unhelpful and undermined consensus merely to state that the issue was closed. She suggested, for example, that some form of cross-referencing should be included in recommendation 204. At all events, the discussion should be deferred until the recommendations on financial contracts had been considered.

65. **The Chairperson** said that the decision on recommendation 204 had been based not only on the discussions in the Working Group and the Commission but also on six years of negotiations regarding the Assignment Convention, in which the United Kingdom had participated. She took it, however, that the Committee agreed to include cross-references to the group of relevant recommendations.

66. *Recommendation 204 was adopted on that understanding.*

67. **Mr. Voulgaris** (Greece) drew attention to the issue of industrial and intellectual property rights, which were subject to registration. In his view, registered industrial and intellectual property rights should be governed by the law of the State in which the registration took place.

68. **Mr. Bazinas** (Secretariat) said that the language that had been included in a previous version of recommendation 204 concerning the law that would determine the location of the registry for intangibles subject to registration had been deleted pending discussion of a project relating to security rights in intellectual property and the proposals emanating from the Colloquium on Security Interests in Intellectual Property Rights held in Vienna in January 2007 (A/CN.9/632). The commentary would explain how the draft Guide should be applied in principle to security rights in intellectual property pending completion of any future project, on the understanding that some recommendations might prove to be inappropriate

and that enacting States might need to adjust their legislation. In cases of inconsistency, intellectual property law would prevail.

Recommendation 205

69. **Mr. Bazinas** (Secretariat) said that the note to the Commission following recommendation 205 related to the second sentence of that recommendation, which stipulated that in a priority conflict involving the rights of competing creditors that were registered in an immovable property registry, the law of the location of the registry should be applied. The note suggested restricting the scope of that rule to situations in which registration in the immovable property registry had priority consequences. If registration had no bearing on priority issues, the law of the location of the assignor would apply.

70. **Mr. Sigman** (United States of America) expressed support for the suggestion in the note to the Commission. The same principle would be applicable to recommendation 202 and to any other provision relating to a registry. He therefore proposed that each reference to an asset-based registry should be reviewed in order to determine whether registration had priority consequences, as opposed to tax or other consequences unrelated to priority.

71. **The Chairperson** said that, if she heard no objection, she would take it that the Committee concurred with the proposal made by the representative of the United States and wished to act on the suggestion contained in the note to the Commission.

72. *It was so decided.*

73. *Recommendation 205, as amended, was adopted.*

Recommendation 206

74. **The Chairperson** reminded the Committee that the Working Group had decided, after extensive and inconclusive discussion, to present two alternatives, A and B, in the recommendation.

75. **Mr. Wiegand** (Switzerland) expressed strong support for alternative B, which effectively balanced the interests of the client and the bank on the basis

of party autonomy. He had so far failed to hear any convincing argument regarding the interests that alternative A was designed to protect.

76. **Mr. Umarji** (India) expressed support for alternative A, which established that the law of the State in which the bank maintaining the account had its place of business should be applied. As banks were required to comply with a variety of rules concerning, inter alia, taxation, suspicious transactions and money-laundering, it was only logical that matters relating to security rights in a bank account should be governed by the law of the location of the bank.

77. **Mr. Riffard** (France), supported by **Ms. Kaller** (Austria), said that alternative A did not seek to protect the interests of any particular party and was thus the most objective solution.

78. **Mr. Sigman** (United States of America), supported by **Ms. McCreath** (United Kingdom), said that although he strongly felt that alternative B was more neutral and easier to apply, he proposed, in the light of the persistent divergence of opinion, that both options should be retained.

79. **Ms. Kolibabska** (Poland) said that, in the light of an extensive debate in Poland on the subject matter of recommendation 206, she supported alternative A as the option that was more conducive to stability.

80. **Mr. Cochard** (Observer for the Association française des entreprises privées) expressed support for alternative A, which was preferable both on account of its consistency with other regulations applicable to banks and in the interests of legal certainty. It was far easier to determine the applicable law on the basis of the location of a bank than by seeking to obtain access to an account agreement.

81. **Mr. Patch** (Australia) asked how alternative A would apply to a situation in which a bank account was not to be found in any physical location but was maintained by an Internet bank.

82. **The Chairperson** said that the issue had been discussed in the Working Group and had given rise to conflicting views.

83. She took it that, in view of the strongly held views on both sides, the Committee wished to retain

both alternative A and alternative B. The commentary would reflect the policy reasons underlying each approach.

84. *It was so decided.*

85. *Recommendation 205 was adopted.*

The meeting rose at 5.05 p.m.

**Summary record of the 842nd meeting, held at the Vienna International Centre
on Thursday, 28 June 2007, at 9.30 a.m.**

[A/CN.9/SR.842]

Chairman: Ms. Sabo (Chairperson of the Committee of the Whole) (Canada)

The meeting was called to order at 9.45 a.m.

**Adoption of a draft UNCITRAL Legislative Guide
on Secured Transactions and possible future work**
(continued) (A/CN.9/617, 620, 631 and Add.1-11,
632 and 633)

*XIII: Private international law (A/CN.9/631 and
Add.10)*

Recommendations 207 to 213

1. *Recommendations 207 to 213 were adopted.*

Recommendation 214

2. **Mr. Bazinas** (Secretariat) said that recommendation 214 was the result of a last-minute compromise reached by Working Group VI. It stated that the enforcement of a security right in tangible property should be governed by the law of the State where enforcement took place, while the enforcement of a security right in intangible property should be governed by the law of the State whose law governed the priority of a security right.

3. As the term enforcement might refer to acts such as notification, repossession, sale or redistribution of proceeds occurring in different countries, and as collateral might be tangible property before a sale but intangible property afterwards, the Secretariat had suggested in a note following the recommendation that the Commission might wish to consider whether one law — the law governing priority — should be made applicable to the enforcement of security rights in both tangible and intangible property. In the case of tangible property, the place of enforcement of security rights would in most cases be the place where the asset was located and the law of that State would govern priority. In the case of intangible property, enforcement would take place in the State of the location of the grantor and the law of that State would govern priority.

4. **Mr. Deschamps** (Canada) expressed support for the Secretariat's suggestion.

5. **Ms. Kaller** (Austria) expressed a preference for the wording as it stood because there could be cases in which tangible property was located in a different State from the State whose law governed enforcement.

6. **Mr. Riffard** (France), referring to the statement in the Secretariat note to the effect that the place of enforcement of security rights in tangible property in most instances would be the place of location of the asset, asked whether the words "in most instances" referred to the exceptions mentioned in recommendation 202, on the one hand with respect to security rights in tangible property of a type ordinarily used in more than one State, which were governed by the law of the State in which the grantor was located, and on the other hand with respect to security rights in the same kind of tangible property that were subject to a specialized registration system, which were governed by the law of the State under the authority of which the registry was maintained. If so, he could foresee a potential inconsistency between the suggestion in the note to the Commission and recommendation 202.

7. **Mr. Deschamps** (Canada) said that the law governing priority and the law applicable to enforcement should ideally be the same because difficulties would arise where a State's enforcement rules prevented it from giving full effect to another State's priority rules. In the case of property subject to a specialized registration system, the property would in all likelihood be located in the State under whose authority the register was maintained, so that there would be few cases in which the law applicable to enforcement was different from that of the location of the property.

8. **Mr. Smith** (United States of America) said that, while he was unable to support either the wording as it stood or the Secretariat's suggestion,

he had been persuaded by the representative of Canada that there was some virtue in aligning the conflict-of-law rules on enforcement with those on priority.

9. **Mr. Ghia** (Italy) expressed a preference for the existing text, which ensured greater balance and effectiveness of enforcement.

10. **Ms. Okino Nakashima** (Japan), supported by **Mr. Kemper** (Germany), said that she agreed with the representative of Italy. Matters affecting the enforcement of a security right included both substantive and procedural matters, and enforcement might involve either judicial or extrajudicial remedies. She therefore believed, as stated in recommendation 214 (a), that the enforcement of a security right in tangible property should be governed by the law of the forum.

11. **Mr. Bazinas** (Secretariat) said that the words “in most instances” referred to the fact that the place of enforcement of security rights in tangible property was usually — but not always — the place of location of the asset, since it could, for instance, be the place where the registry was maintained. That was also true of certain intangibles, as stipulated in recommendation 107.

12. **Mr. Riffard** (France) said that the Secretariat’s suggestion, according to which the place of enforcement of security rights in tangible property would — in most instances — be the place of location of the asset, was a clearer and more objective option.

13. **Mr. Deschamps** (Canada) said that the term “place of enforcement” was vague since it was not always clear where enforcement took place. For example, a secure creditor in State A might apply to a court in that State to enforce a security right in property located in State B. State A might thus be regarded as the “place of enforcement” although the property was located elsewhere. He proposed including both the existing text and the Secretariat’s suggestion as alternative options.

14. **Ms. Kaller** (Austria) expressed support for the existing text. Difficulties would arise if the judgement of a court in one State had to be recognized by courts in other States. Moreover, there were procedural and not just conflict-of-law issues involved. States that did not recognize

extrajudicial enforcement would not tolerate a foreign creditor entering a debtor’s home to seize property in settlement of a debt.

15. **Mr. Sigman** (United States of America) expressed support for the proposal by the representative of Canada that alternative options should be presented. He also agreed with the point made by the representative of Austria regarding judicial and extrajudicial enforcement. As there was no forum in the context of non-judicial enforcement, a rule was needed that worked equally well for both types of enforcement. While he would not normally support alternative options in a conflict situation, he was willing to make an exception in the current case because the existing recommendation failed to provide the certainty required of a conflicts rule.

16. **Mr. Bazinas** (Secretariat) asked the Committee how a rule referring to the law governing priority would be applied in jurisdictions where there was no concept of priority or, more generally, where priority was not distinguished from creation and third-party effectiveness. He also asked how such a rule would be applied to acquisition financing rights, given that even part of the draft Guide did not use the term “priority” for the non-unitary approach.

17. **Mr. Perezniето Castro** (Mexico) expressed support for the existing text and noted that the procedural aspects of enforcement dealt with by the courts should not be confused with the law applicable to enforcement. The draft Guide provided sufficient clarity in that regard and expanding it further could lead to confusion.

18. **Mr. Riffard** (France) said that the note to the Commission provided an answer to the question raised by the Secretariat regarding the concept of priority. He proposed deleting the phrase “and the law of that State would govern priority” in the second and third sentences of the note referring to tangible and intangible property respectively.

19. **Mr. Bazinas** (Secretariat) asked whether in that case the reference to the location of the asset for tangible property and to the location of the grantor for intangible property should become a clear-cut rule, or whether provision should be made for exceptions, for instance the law of the State maintaining a registry.

20. **Mr. Deschamps** (Canada) said that amending the text in the manner proposed by the representative of France would create problems because, as the Secretariat had just pointed out, exceptions would need to be made. However, the Committee should not be unduly concerned about the fact that the non-unitary approach in the acquisition financing chapter did not use the term “priority”, since the conflict rules would be construed as being applicable to the non-unitary system and the terms used would be adapted accordingly. Thus, the term “priority”, interpreted broadly, would cover any situation in which there was a conflict between competing rights.

21. **Mr. Sigman** (United States of America), supported by **Mr. Ghia** (Italy), proposed explaining the broad interpretation of the term “priority” in the commentary.

22. **Ms. Stanivuković** (Serbia) said that it was important to make a distinction between substantive and procedural issues. The term “priority” related to substantive issues, which would be governed by the priority rules already established. Procedural issues, on the other hand, could be governed only by the law of the place of enforcement — the *lex fori*. She therefore suggested inserting the word “procedural” before “matters” in the chapeau of the existing text of recommendation 214. She also wondered whether subparagraph (b) of the recommendation might be superfluous.

23. **Mr. Bazinas** (Secretariat) drew attention to the commentary on the law applicable to the enforcement of a security right, contained in paragraphs 56 to 58 of document A/CN.9/631/Add.10, which provided clarifications on substantive and procedural matters.

24. **Mr. Sigman** (United States of America) asked whether extrajudicial enforcement was in any way procedural. If not, he proposed that the commentary should state clearly that the distinction between substance and procedure was relevant only in the case of judicial action and that it was irrelevant in the case of extrajudicial enforcement.

25. **Mr. Bazinas** (Secretariat) said that procedural issues might arise at some point in extrajudicial enforcement and that those issues could be discussed in the commentary.

26. **Mr. Ghia** (Italy) expressed support for the original wording of recommendation 214. Any additional relevant points could be included in the commentary.

27. **The Chairperson** said she took it that the Committee wished to adopt the original version of recommendation 214 and to discuss other approaches, including that contained in the note to the Commission, in the commentary.

28. *It was so decided.*

29. *Recommendation 214 was adopted.*

Recommendation 215

30. **Mr. Voulgaris** (Greece) noted that recommendation 215 reflected the approach adopted in the United Nations Convention on the Assignment of Receivables in International Trade (the United Nations Assignment Convention), namely that the location of the grantor meant the place where the grantor’s central administration was exercised. He would have preferred a reference to the location of the branch of the grantor that was most closely connected to the security agreement.

31. *Recommendation 215 was adopted.*

Recommendation 216

32. **Mr. Voulgaris** (Greece) said that the reference to the “time of the creation” of a security right in recommendation 216 (a) was unduly vague and might cause confusion.

33. **Mr. Bazinas** (Secretariat) said that “the time of creation” was dealt with in recommendation 12.

34. **Mr. Cohen** (United States of America) said that the representative of Greece had been right to draw attention to the problems arising from the phrase “time of the creation”. A conflict-of-law issue would arise if the States involved had different rules as to what constituted creation. Simply to refer to the time of creation failed to resolve that issue, since in some States a security right could be created orally, while in other States it had to be created in writing. It might be preferable to use a form of words along the following lines: “the time at which it is asserted that the right was created”.

35. **Ms. Walsh** (Canada) said that the appropriate term might be “putative creation” of the security right.

36. **Ms. Stanivuković** (Serbia) suggested the phrase “purported creation”.

37. **The Chairperson** said she took it that the Committee wished to amend the recommendation along those lines and that it would leave the final wording to the Secretariat.

38. *It was so decided.*

39. *Recommendation 216 was adopted on that understanding.*

Recommendation 217

40. *Recommendation 217 was adopted.*

The meeting was suspended at 11.05 a.m. and resumed at 11.35 a.m.

Recommendation 218

41. **Mr. Deschamps** (Canada) proposed amending recommendation 218 (c) to read: “The rules in subparagraph (a) and (b) of this recommendation do not permit the application of the provisions of the substantive law of the forum on third-party effectiveness or priority of a security right as against the rights of competing claimants.” That wording was based on the corresponding provision of the Assignment Convention. The purpose of subparagraph (c) was to make it clear that if the conflict rules of the draft Guide called for the application of a foreign law to third-party effectiveness or priority, the forum court could not invoke public-policy principles to disregard those rules. However, public-policy principles could be invoked to prevent the application of a foreign law to other matters such as creation. If, for instance, the foreign law permitted the creation of a security right in wages and the public-policy rules of the forum did not, those rules could be invoked to disregard the foreign law.

42. **Mr. Bazinas** (Secretariat) asked whether the addition of the word “substantive” was necessary in the light of the rule in recommendation 217. He assumed that the reason for deleting the final phrase of the original version, which read “unless the law of the forum is the applicable law under the

provisions of this law on private international law”, was that it could be tacitly understood.

43. **Ms. Walsh** (Canada) said that the exclusion of the renvoi rule in recommendation 217 dealt with a different point. The proposed insertion of the word “substantive” in recommendation 218 (c) was intended to clarify that the substantive provisions of the law of the forum on third-party effectiveness or priority of a security right could not be applied. She drew attention to an analogous use of the word “substantive” in recommendation 220.

44. **The Chairperson** pointed out that that the word “law” had been taken to mean “substantive law” throughout the draft Guide. She said she took it that the Committee agreed to adopt the amended version of the recommendation with the deletion of the word “substantive”.

45. *It was so decided.*

46. *Recommendation 218, as amended, was adopted.*

Recommendations 219 and 220

47. **The Chairperson** drew attention to the suggestion in a note following recommendation 220 that recommendation 219 (b) should be deleted since it was covered, in substance, by recommendation 220.

48. **Mr. Deschamps** (Canada) expressed support for the proposal.

49. **The Chairperson** said she took it that the Committee wished to delete recommendation 219 (b) and leave it to the Secretariat to make any consequential changes to the wording of recommendations 219 and 220.

50. *It was so decided.*

51. *Recommendations 219 and 220 were adopted on that understanding.*

Recommendations 221 and 222

52. *Recommendations 221 and 222 were adopted.*

Commentary to chapter XIII: Private international law (A/CN.9/631/Add.10)

Paragraph 1

53. *The substance of paragraph 1 was approved.*

Paragraph 2

54. **Mr. Deschamps** (Canada) said that paragraph 2 of the commentary was inconsistent with the principles underlying the pertinent recommendations in the draft Guide. It stated that courts must determine whether a case was domestic or international as a prerequisite for the application of conflict-of-law rules. The criteria on which the court would base that decision were not specified in the commentary, which merely referred to the general rules of private international law of the forum. It followed that a court might decide that a case was not international even if the conflict rule set out in the draft Guide indicated that a foreign law was applicable. Such an approach would be inconsistent with recommendation 218 and the relevant sentences should be deleted from paragraph 2.

55. **Mr. Sigman** (United States of America) expressed strong support for the proposal by the representative of Canada.

56. **Mr. Voulgaris** (Greece) also expressed support for the proposal. He further proposed deleting the terms “forum”, “tribunal” and “court”, since they gave the impression that contentious issues were invariably involved. He therefore suggested amending the phrase “only if the forum is in a State” in the first sentence to read “only if the transaction is examined in a State”.

57. **The Chairperson** said that, while the terms to which the representative of Greece objected were not ideal, she doubted whether there were any generally acceptable alternative terms. However, she took it that the Committee wished to leave it to the Secretariat to redraft the paragraph in the light of the proposals made by the representatives of Canada and Greece.

58. *It was so decided.*

59. *The substance of paragraph 2 was approved subject to the agreed amendments.*

Paragraphs 3 to 13

60. *The substance of paragraphs 3 to 13 was approved.*

Paragraph 14

61. **Mr. Voulgaris** (Greece) proposed that paragraph 14 should be reviewed to avoid any implication that all legal systems adopted an identical position on the application of the law of the location of the asset to the creation of a security right as between the parties.

62. *The substance of paragraph 14 was approved subject to the agreed amendment.*

Paragraphs 15 to 34

63. *The substance of paragraphs 15 to 34 was approved.*

Paragraphs 35 to 47

64. **Ms. McCreath** (United Kingdom), drawing attention to the links between paragraphs 35 to 40 and recommendation 204, proposed including cross-references in those paragraphs along the lines of those agreed in respect of the recommendation. Moreover, as overlapping issues pertaining to financial contracts remained pending, she proposed that approval of paragraphs 35 to 40 should be deferred.

65. **Mr. Wezenbeek** (Observer for the European Union) expressed support for the points made by the representative of the United Kingdom. The issue addressed in recommendation 204 was the subject of intense debate in the European Union in the context of the European Commission proposal for a regulation on the law applicable to contractual obligations (Rome I). Given the highly complex nature of the issue, the discussions were likely to continue for some time.

66. **Mr. Bazinas** (Secretariat) said that UNCITRAL had taken six years to negotiate the United Nations Assignment Convention, which had been adopted by the General Assembly. The Commission had therefore resolved the issue of the law governing receivables versus the law of the assignor. The adoption of a consistent rule in the draft Guide was the product of yet another six years of negotiations.

67. No reference had been made in the recommendations or the commentary to the proposed regulation on the law applicable to

contractual obligations (Rome I) because it had not been finalized. The only draft available adopted the assignor's law with certain differences in the definition of the location rule. Moreover, the only official statement in that regard at the Commission's thirty-ninth session had been to the effect that the European Commission shared UNCITRAL's concerns regarding the potential impact of the adoption of a different law on receivables financing as a whole and was prepared to develop a consistent approach so that a uniform conflict-of-law rule could be adopted. Although UNCITRAL appreciated that the finalization of the Rome I document was a complex and time-consuming process, it could not be expected to amend rules adopted after lengthy negotiations to achieve consistency with a draft instrument. While it had always been open to regional harmonization efforts, it could not be bound by such efforts inasmuch as the United Nations and UNCITRAL were required to represent the international community as a whole.

68. **Ms. McCreath** (United Kingdom) said that the aim of the current discussion was to reach consensus on the best possible draft Guide. To that end, efforts must be made to adapt to the needs of a changing global environment. The receivables financing industry in the United Kingdom was arguably the largest in Europe and operated on the basis of a very different conflicts law from that proposed in the draft Guide at present.

The meeting rose at 12.30 p.m.

**Summary record of the 843rd meeting, held at the Vienna International Centre
on Thursday, 28 June 2007, at 2 p.m.**

[A/CN.9/SR.843]

Chairman: Ms. Sabo (Chairperson of the Committee of the Whole) (Canada)

The meeting was called to order at 2.10 p.m.

**Adoption of a draft UNCITRAL Legislative Guide
on Secured Transactions and possible future work
(continued)** (A/CN.9/617, 620, 631 and Add.1-11,
632 and 633)

*Commentary to chapter XIII: Private international
law (continued)* (A/CN.9/631/Add.10)

Paragraphs 35 to 47 (continued)

1. **The Chairperson** said that the Committee's discussion later in the meeting of financial contracts might affect the scope of the draft Guide, which might in turn affect the impact — though not the substance — of recommendation 204 and hence the text of paragraphs 35 to 40 of the commentary to chapter XIII.

2. **Mr. Burman** (United States of America) said that all the relevant transactions had been exhaustively discussed by the Commission when the United Nations Convention on the Assignment of Receivables in International Trade (the United Nations Assignment Convention) was being drafted. That process had led not only to the selective treatment of financial contracts in the Convention but also to the inclusion of exceptions and the listing of diverse practices. While transactional practices were continually evolving, all the fundamentals were addressed in the Convention and no substantial changes had occurred that would warrant reconsideration of the issues involved.

3. **Mr. Cochard** (Association française des entreprises privées), referring to paragraphs 42 to 44 of the commentary and the two alternatives set out under recommendation 206, suggested that, in the light of the report of Working Group VI (Security Interests) on the work of its twelfth session (A/CN.9/620), the commentary should state that the majority of member States supported alternative A, i.e. the law of the State in which the bank that

maintained the account had its place of business or, in the case of more than one place of business, the law of the State in which the branch maintaining the account was located.

4. **The Chairperson** said that the Working Group had decided to place the two alternatives on an equal footing. The question of whether a majority of members of the Working Group had supported either alternative was therefore no longer relevant and it would be inappropriate to mention it in the commentary, which was to be adopted by consensus.

5. **Ms. Kaller** (Austria) proposed mentioning in paragraph 38 of the commentary that there were alternative solutions to those set out in the Assignment Convention.

6. **Ms. Walsh** (Canada) said that, while it was possible for reasonable people to disagree on any legal issue, the issue under discussion was one of choice of law relating to priority between competing third-party rights. A choice-of-law rule would not achieve its purpose if States could shop around between different choice-of-law rules governing issues of priority and third-party effectiveness. The consequence of providing options in that area was that one secured creditor might be awarded priority under the law applicable pursuant to State A's choice-of-law rule, while another secured creditor might enjoy a superior claim under the law applicable in State B, which applied a different choice-of-law rule. That state of affairs was not conducive to predictability or certainty in the ordering of priorities. Leaving States free to choose between different approaches would encourage a race to different forums in order to take advantage of the most favourable choice-of-law rule. Although it was unfortunate that States, for instance those engaged in negotiations on the European Commission proposal for a regulation on the law applicable to contractual obligations (Rome I), had been unable to reach agreement on a rule that was consistent with

that laid down in the Assignment Convention, the Commission could not change the decisions adopted in the context of such an instrument, which, unlike a legislative guide, was intended to promote uniformity. The whole object of adopting a choice-of-law rule had been to ensure global uniformity.

7. **Mr. Bazinas** (Secretariat), thanking the representative of Canada for her vote of confidence in the Commission, expressed disappointment at other States' lack of confidence in the Assignment Convention that they had actively helped to draft. The recommendations on receivables contained in the draft Guide had not been formulated as general recommendations with alternatives because the Working Group and the Commission had decided to adopt the approach set out in the Assignment Convention. It would be somewhat odd if the Commission were to undermine in a legislative guide the acceptability of one of its own recent instruments, especially in order to reinforce a particular negotiating position in a standard-setting process under way in another forum.

8. **The Chairperson** said she took it that the Committee wished to approve the substance of paragraphs 35 to 47, subject to any modifications that might become necessary in the light of the discussion of financial contracts and with the cross-referencing proposed by the representative of the United Kingdom at the previous meeting.

9. *It was so decided.*

10. *The substance of paragraphs 35 to 47 was approved on that understanding.*

Paragraphs 48 to 64

11. **Mr. Bazinas** (Secretariat), referring to paragraph 56, said that every effort would be made to ensure that the commentary reflected the main points raised during the discussion at the previous meeting regarding recommendations on the law applicable to enforcement, including the point that, in the absence of judicial enforcement, the question of whether an issue was procedural or substantive was irrelevant. The commentary would clarify that recommendation 214 was intended to deal with substantive matters of enforcement and not to undermine the generally accepted rule that

procedural matters were subject to the law of the place where enforcement occurred.

12. *The substance of paragraphs 48 to 64 was approved subject to the agreed amendments.*

Paragraphs 65 to 75

13. *The substance of paragraphs 65 to 75 was approved.*

Preliminary discussion of financial contracts

14. **Mr. Murray** (United Kingdom) said that it was the position of the United Kingdom that financial contracts constituted a special type of intangible property that was used in the context of special types of markets, i.e. financial markets, and that further technical work on the topic was needed to ensure that the rules in the draft Guide were appropriately applicable and did not interfere with common financial-market practice and the requirements of efficiency and transparency. As the Working Group had not yet focused on financial contracts as a specific type of collateral, financial contracts could not be properly addressed in the draft Guide at the current stage of the discussions.

15. Financial contracts should be treated as a form of collateral rather than as collateral arrangements. While the definition of financial contracts in the Assignment Convention could serve as a starting point, there was some concern that its scope needed to be broadened. Financial contracts were, broadly speaking, assignments of positions entered into on regulated exchanges, financial contracts governed by a netting agreement and foreign exchange transactions. Other types of financial contracts, such as bank deposits and independent undertakings, had already been defined in the draft Guide and were subject to separate rules. He would therefore focus on over-the-counter derivatives, which were typically subject to netting agreements, spot foreign exchanges, repurchase agreements and securities lending as forms of collateral rather than as collateralized transactions, which was somewhat confusing since they served both purposes. In the context of structured financings, they virtually all now included hedging transactions, involving interest rates, currencies and occasionally credit. The core transaction of synthetic securitization was actually a credit derivative. The benefits of hedging

contracts entered into by the special-purpose vehicle in structured financing were always made part of the security package. It followed that such types of intangible property were used as collateral and must therefore be subject to clear rules.

16. With regard to the conflict-of-law rule relating to security in a financial contract, he submitted that it would not be inconsistent with the Assignment Convention to develop a separate rule because financial contracts were carved out of the Convention.

17. He strongly believed that the best way of establishing priority in financial contracts as a form of collateral was via the concept of control. The definition of control in the draft Guide was limited to bank deposits and independent undertakings and was not broad enough to cover what he meant by financial contracts. It should be made clear that control was the principal and, ideally, the exclusive means of perfecting security in a financial contract and that control trumped registration. In fast-moving financial markets, even if registration was unnecessary, it could create confusion if some parties believed that they should register to be on the safe side. It would therefore be preferable to make it clear that control was the way to perfect a security interest in a financial contract.

18. Recommendation 25, which contained the prohibition of anti-assignment clauses, was in theory limited to receivables, but he doubted whether the current definition of a receivable effectively excluded financial contracts. He noted that the recommendation included a carve-out referring to contracts for the supply of financial contracts, but he did not think that that concept was clear and broad enough to cover everything that was denoted by the term financial contract.

19. **Mr. Burman** (United States of America) said that the representative of the United Kingdom had raised important points, some aspects of which might well be included in the draft Guide following careful deliberation in the light of practice and of the Assignment Convention. The issues raised could be discussed intersessionally and recommendations drafted in informal consultations for consideration by the Commission at its resumed session in December 2007.

20. **Mr. Smith** (United States of America) welcomed the willingness of the representative of the United Kingdom to work with the definitions and exclusions set out in the Assignment Convention as a way of limiting any adjustments that might need to be made for the purposes of the draft Guide. He noted that while the Assignment Convention excluded financial contracts, as defined in that instrument, it only excluded those that were subject to netting agreements and some others such as foreign exchange contracts and securities lending arrangements. As the draft Guide contained asset-specific recommendations, any further consideration of the issue of financial contracts should be guided by the aim of including, with possible adjustments, asset-specific rules on financial contracts that were consistent with the definition and scope of treatment of those devices in the Assignment Convention.

21. **Mr. Murray** (United Kingdom) asked whether the representative of the United States, who had mentioned the possibility of adjustments, had any views on the question of perfecting a security interest in financial contracts.

22. **Mr. Smith** (United States of America) said that his delegation had an open mind on the question of control as an exclusive or non-exclusive means of creating effectiveness against third parties. The concept existed in the United States only in relation to securities and other investment property, deposit accounts and letters of credit.

23. **Mr. Werner** (International Swaps and Derivatives Association) said that the global derivatives industry was very much concerned with the issue of financial contracts. In general, the industry regarded the draft Guide as a helpful tool, particularly for law reform in emerging markets, which played an increasingly important role in financial, capital and “developed” markets. The inclusion in the draft Guide of financial contracts and securities and their treatment as a form of collateral was of crucial importance to the derivatives industry. However, the definition of financial contracts must be both sound and up to date, and many of the technical details clearly remained to be discussed. As whatever definition was adopted would remain set in stone for many years to come, he suggested setting aside the issue of financial contracts for the time being so that the

Commission could adopt the remaining parts of the draft Guide. Financial contracts could then be discussed in more detail in whatever deliberative body was deemed to be appropriate.

24. **Ms. McCreath** (United Kingdom) said that she was encouraged to note the willingness of the United States delegation to consider arguments in support of the concept of control. However, as the Committee was engaged in a preliminary discussion, it was unnecessary for the time being to examine the desirability of including or excluding such concepts, since it might lead to a lengthy and premature discussion of the respective positions of States.

25. **The Chairperson** said that it was unclear whether the financial contracts enumerated by the representative of the United Kingdom were intended as a closed or an illustrative list.

26. **Mr. Smith** (United States of America) said that the Committee needed to have a stable idea of what it meant by a financial contract. While he appreciated the fact that the financial contract industry was constantly developing new products, it should be borne in mind that the Assignment Convention contained a definition of a financial contract that had been heavily influenced by contributions from the International Swaps and Derivatives Association and other market players and that was also flexible because it referred not only to specific transactions but also to “similar” transactions. He suggested that, in order to ensure consistency with that Convention, the Committee should maintain that definition and explain in the commentary why UNCITRAL believed that new products developed since the Convention’s entry into force would fall within the definition of financial contract as “similar” transactions.

27. **Mr. Murray** (United Kingdom) said that while the definition of financial contracts contained in chapter II, article 5 (k), of the Assignment Convention might be a useful starting point, and while he recognized the value of stability and consistency, his understanding of the term was that it included not only many of the transactions listed in article 4 (2) of the Convention but also other transactions that he would identify in due course. The definition should therefore be broad enough to encompass what the financial markets deemed to be financial contracts and to ensure that the instrument

remained valid and did not need to be reviewed in the light of developments in the markets. In early netting legislation, for example, it was common to include relatively prescriptive and closed lists of financial contract types. As a result, virtually every jurisdiction, including the United States, had been obliged to review and amend its definition of financial contracts on more than one occasion. The Commission should therefore be ambitious in seeking a broad, flexible and open definition.

28. **Mr. Bazinas** (Secretariat) said that the Commission, when drafting the Assignment Convention, had excluded financial contracts governed by netting agreements and a number of other transactions because it considered that some of the provisions of the Convention were not appropriately applicable to such transactions. Two main issues had been identified: the applicable law rule and the prohibition of anti-assignment clauses. The question of whether to include certain financial and other similar contracts in the draft Guide, adjusting the draft accordingly, or to exclude them would have to be considered in the context of the discussion of securities, since the outcome of that discussion would have implications for the discussion of financial contracts. The Assignment Convention focused on exclusions and other limitations, and the definitions served as tools to achieve that result. It might therefore be difficult to identify definitions before deciding whether the goal was to be inclusion or exclusion. Any inclusions should be consistent with the Convention, and so should any modifications of the provisions on anti-assignment clauses or applicable law introduced to address the practices involved in financial contracts.

29. **Mr. Deschamps** (Canada) said that the speakers who were suggesting that different rules from those proposed in the draft Guide should apply in some instances to financial contracts seemed to assume that existing law worked well. He invited the observer for the International Swaps and Derivatives Association or the representative of the United Kingdom to provide examples of existing laws that worked well in respect of, for instance, the perfection of a security interest in the rights of a counterparty under a derivative contract or under a foreign exchange agreement.

30. **Mr. Murray** (United Kingdom) said that the issue raised by the representative of Canada could not be adequately addressed in a preliminary discussion but would form part of the technical work needed to decide on what adjustments should be made to the draft Guide.

31. Noting that the Secretariat had not mentioned the issue of appropriate ways of perfecting a security interest in a financial contract, he requested reassurance that that was one of the issues that would be discussed.

32. The concept of control did not exist under English law but it had recently been introduced into the United Kingdom by the European Union Financial Collateral Arrangements Directive. A related issue was the question of characterization, i.e. whether assignment of a receivable was characterized as a transfer of title to the receivable or as a security transaction. He suggested that it might be addressed in the context of securities.

33. **Mr. Burman** (United States of America) noted the importance of coordination with the work of the International Institute for the Unification of Private Law (Unidroit) on a preliminary draft Convention on Substantive Rules regarding Intermediated Securities.

34. **Mr. Umarji** (India) asked whether the receivable under a financial contract involving, for instance, hedging against changes in interest rates or exchange rates would be accepted in practice as a valid security and whether money would be advanced against it despite the uncertainties involved.

35. **Mr. Murray** (United Kingdom) said that while it was true that a financial contract which was an over-the-counter derivative would typically have an uncertain value or indeed no value at all at the time it was assigned by way of security to the secured party, if an enforcement occurred before the contract had matured or resulted in a payment obligation, the secured party stood in the place of the grantor in relation to the contract. Any ultimate pay-out under the derivative would go to the secured party. Thus, if a corporate borrower entered into an interest-rate hedge in relation to its loan, it might be entitled to a close-out payment, for example in the event of a default by the bank that had provided the hedge.

It would typically assign the benefit of that contingent payment to the lenders.

36. **Ms. McCreath** (United Kingdom) stressed that any further work on the topic under discussion should be undertaken by Working Group VI rather than by an intersessional group.

37. **Mr. Burman** (United States of America) said that while he agreed that it should be a Working Group project, informal intersessional consultations could assist in clarifying the issues before the Commission met in formal session. The outcome of the consultations would not, of course, be in any way binding.

38. **Mr. Riffard** (France) said that it was important not to lose sight of the fact that the draft Guide was intended primarily for legislators who lacked effective legislation and that it should therefore be simple, understandable and readable. He had already expressed concern that proposals to include asset-specific provisions such as security rights in proceeds under an independent undertaking might render the draft Guide unduly sophisticated and complex. The same applied to financial contracts. If security rights in financial contracts necessitated a special study and adaptation of the general rules of the draft Guide, it might be necessary to defer work on the topic and address it in an annex that could be used by legislators who were familiar with financial contracts.

39. **Mr. Bazinas** (Secretariat) said that securities and financial contracts might be referred to Working Group VI as areas for future work. The question of security interests in intellectual property would probably also be referred to the Working Group, subject to approval by the Commission. In the meantime, however, a decision must be taken on how to deal with the remainder of the text of the draft Guide. He drew attention to the qualified inclusions in recommendation 4 (a) and (b) and to the question of the qualified inclusion or exclusion of securities raised in recommendation 4 (c). If the Committee opted for full exclusion of securities, it might wish to develop, as a first step, three or four rules pertaining to financial contracts, such as applicable law, assignment provisions, perfection and characterization. If it opted for the qualified exclusion of securities, it would also have to

consider the implications of that approach for the treatment of financial contracts.

40. **Mr. Burman** (United States of America) said that the Committee might wish to defer its decision on recommendation 4 (c) until the resumed session of the Commission in December 2007. If a decision was to be taken in the coming days, there may be greater justification for exclusion, since the Committee would not have the time needed to examine the issues concerned and to be assured of the support of industry and trade in that regard.

41. **Mr. Pereznieto Castro** (Mexico) expressed support for the comments made by the representative of France. The emerging countries for which the draft Guide was intended needed to use it as a tool as soon as possible. The drafting process, which had begun six years previously, appeared to be interminable, since new issues were added at every session and the instrument was turning into a veritable encyclopaedia of security rights. If States wished to consider other issues, the outcome of their deliberations could be included in annexes to the draft Guide or in other documents.

42. **Mr. Voulgaris** (Greece) and **Mr. Ghia** (Italy) expressed support for the statements by the representatives of France and Mexico.

43. **Ms. McCreath** (United Kingdom) said that she wished to avoid giving the impression that her delegation was seeking to overburden the Working Group and delay finalization of the draft Guide. If the Committee opted for exclusion of financial contracts for the time being, it would be happy to go along with that decision.

44. **The Chairperson** said that it was clear from the preliminary discussion of financial contracts that further technical work was required. Indeed, given the sophisticated nature of such contracts, it might be preferable to hold the topic over for future work. However, if a resumed session of the Commission was held in December 2007, the Committee might wish to consider whether some preliminary work on the subject should be undertaken at that session.

The meeting was suspended at 3.40 p.m. and resumed at 4.15 p.m.

XIV: Transition (A/CN.9/631 and Add.11)

Recommendations 223 to 230

45. *Recommendations 223 to 230 were adopted.*

Commentary to chapter XIV: Transition (A/CN.9/631/Add.11)

46. *The substance of the commentary to chapter XIV was approved.*

VII: Priority of a security right as against the rights of competing claimants (continued) (A/CN.9/631 and Add.4)

Recommendation 107 (continued)

47. **The Chairperson** said that the delegations of the United States of America and Canada had engaged in informal consultations with other interested delegations with a view to preparing a revised version of recommendation 107 concerning priority between competing security rights in property that was subject to a negotiable document.

48. **Mr. Cohen** (United States of America) said that the result of the discussions had been a general recognition, with a limited exception, of the principle that a party that had a security right in tangible property represented by a negotiable document and that had made that security right effective against third parties by possession of the document would have priority over a competing secured party that had a security right made effective by other means. That was consistent with many principles discussed by the Working Group relating to the importance of reliance on negotiable documents. The primary exception arose in cases where at least one of the security rights not only existed but had been made effective against third parties before the goods became subject to the negotiable document. Expectations in such cases might be somewhat different from those in cases where the security rights had been created after the negotiable document came into existence. The proposed new text therefore provided that where the security right had been made effective against third parties before the goods became subject to the negotiable document, the normal rules of priority would apply; thus, the first security right to be made effective against third parties or to become the subject of a registration would apply. However, that

provision did not apply in the case of inventory, because a party that extended credit on the basis of inventory had reason to expect that those goods would be put into commerce, perhaps using a negotiable document such as a bill of lading. With regard to certain contracts that provided for issuance of a document of title, the primary rule was that the document of title prevailed except in a situation where one of the security rights had been made effective against third parties before the goods became subject to the document, and the goods were not inventory.

49. **Mr. Bazinas** (Secretariat), referring to a situation in which a security interest existed before goods had become subject to a negotiable document, in which case the general priority rules would apply, asked how a secured creditor who subsequently took possession of the negotiable document would be affected and how the interests of that person were protected by existing priority rules.

50. **Mr. Cohen** (United States of America) said that there was always a winner and a loser in such circumstances. The proposed revised recommendation provided in the general case that the party in possession of the document would have priority and would therefore be the winner. In the exceptional case, the party that had the pre-existing right in the goods would have priority. As there was a winner and a loser in both cases, the parties had an interest in being able to determine in advance, to the extent possible, whether their position was of first or second priority. There was no perfect solution, since if both parties were acting in good faith, they could both be regarded as deserving of priority.

51. Where the party in possession of the negotiable document prevailed, the party that had extended credit and had made its security right effective against third parties by a means other than possession of the document had, in a sense, chosen to risk being junior in priority. That party would still have reason to determine that the goods were subject to a document, because if they were, the grantor did not have possession of them. If the goods were inventory, even if they were not yet represented by a negotiable document, the very fact that they were inventory would alert the creditor to that possibility.

52. In a situation where the exception applied and a party had made its security right effective against third parties before the goods became represented by the document and those goods were not inventory, the other party, i.e. the party that took possession of the document, would need to be able to ascertain whether it was at risk. As the only other way a security right could be made effective against third parties was by registration, it could, of course, check the registry.

53. Admittedly, neither type of ability to ascertain was perfect and both required work. However, some diligence would also be required under recommendation 107 as currently drafted and under the version suggested in the note to the Commission.

54. **Mr. Voulgaris** (Greece) expressed support for the proposal presented by the representatives of the United States. The solution was fair and complete. As exceptions would be very rare, they were in effect only theoretical.

55. **Ms. Walsh** (Canada) said that the revised recommendation as currently drafted did not appear to produce the policy result envisaged, despite agreement on the policy itself. The delegations concerned therefore needed more time to agree on the precise wording of the text.

56. **The Chairperson** said she took it that the Committee agreed to defer consideration of recommendation 107.

57. *It was so decided.*

XIII: Private international law (continued)
(A/CN.9/631 and Add.10)

Recommendation 202 (continued)

58. **Mr. Bazinas** (Secretariat) said that the note to the Commission following recommendation 202 was designed to address a conflict of priority between a secured creditor with a possessory security right in a negotiable document and a secured creditor with a non-possessory security right in the goods covered by the document. The question was whether the law of the location of the document should be applicable to the conflict. The representative of Spain had suggested expanding that rule to state that wherever goods were subject to a negotiable document and the goods and the document were not in the same place,

all issues with respect to the creation, priority and third-party effectiveness of a security right should be governed by the law of the location of the document. If the Committee wished to include such a recommendation, it would have to consider whether that rule would prevail also with respect to goods in transit or export goods, the subject matter of recommendation 203.

59. The representative of Bolivia had noted that if goods subject to specialized registration were represented by a negotiable document, a possible issue was whether the law applicable to the creation, third-party effectiveness and priority of the security right would be the law of the location of the document or the law of the State in which the specialized registry was maintained.

60. **Mr. Sigman** (United States of America) expressed support for the suggestion in the note to the Commission but not for the suggestion to expand the rule it contained. A rule stipulating that effectiveness was governed by the location of the negotiable document would undermine the basic policy that everything was registrable and that it was necessary to register and to search in only one place. Similarly, it seemed less practical and efficient to have multiple rules governing creation and third-party effectiveness.

61. **The Chairperson** said that, if she heard no objection, she would take it that the Committee wished to insert a new recommendation based on the wording of note to the Commission following recommendation 202.

62. *It was so decided.*

Recommendations 203 and 204 (continued)

63. **The Chairperson** noted that the representative of France had raised the issue, during the discussion of recommendations 203 and 204, of whether a recommendation to address the law applicable to the transfer of security rights by way of assignment should be included in the draft Guide.

64. **Mr. Riffard** (France) said that it was important to determine what law was applicable to the transfer of a security right in the case of assignment of the receivable to which the security right was attached. There were two possibilities: either the law applicable to the assignment contract or the law applicable to the security right that had been transferred.

65. **Mr. Macdonald** (Canada) said that the key question was the extent to which the draft Guide should go beyond secured transactions law and address general conflict-of-law rules. He cautioned against recommending a special conflicts rule governing the transfer of obligations where those obligations were backed by a security right of the type identified by the draft Guide, since it would require States to ascertain whether that rule was in conformity with the general conflicts rule they applied to the transfer of obligations. While the point raised was very important, he felt that it should be addressed in the commentary rather than in a recommendation.

66. **Mr. Riffard** (France) said that he agreed with the representative of Canada that an additional recommendation was unnecessary and could potentially raise more questions than it resolved. He would therefore be satisfied if the issue were addressed in the commentary.

67. **The Chairperson** said that, if she heard no objection, she would take it that the Committee wished to have the issue addressed in the commentary.

68. *It was so decided.*

The meeting rose at 5 p.m.

**Summary record of the 844th meeting, held at the Vienna International Centre
on Friday, 29 June 2007, at 9.30 a.m.**

[A/CN.9/SR.844]

Chairman: Ms. Sabo (Chairperson of the Committee of the Whole) (Canada)

The meeting was called to order at 9.50 a.m.

**Adoption of a draft UNCITRAL Legislative Guide
on Secured Transactions and possible future work**
(continued) (A/CN.9/617, 620, 631 and Add.1-11,
632 and 633; A/CN.9/XL/CRP.7)

XII: Acquisition financing rights (continued)
(A/CN.9/631)

*Section B: Non-unitary approach to acquisition
financing rights (continued) (recommendations 184
to 201)*

Terminology and rules of interpretation
(A/CN.9/631/Add.1)

*Proposal by the Canadian delegation on acquisition
financing (non-unitary approach)*
(A/CN.9/XL/CRP.7)

1. **The Chairperson** invited the Canadian delegation to introduce document A/CN.9/XL/CRP.7 containing a proposed revised version of recommendations 184 to 201 of the draft Guide concerning the non-unitary approach to acquisition financing rights. She noted that other delegations had been given an opportunity to comment on an earlier draft.

2. **Mr. Macdonald** (Canada) said that his delegation had not sought to change the substance of the recommendations. Its main objective had been to reformulate them in a manner that was consistent with the idea of security arising from ownership and, as far as possible, to follow the logic and order of the recommendations contained in the unitary approach section.

3. For the sake of clarity, some of the relevant definitions contained in document A/CN.9/631/Add.1 had been reformulated. As the term “acquisition financing right”, however accurately or appropriately defined by Working Group VI, was not a well-known or easily understood concept, it had been decided, for the sake of transparency, to

repeat the terms “retention-of-title right” and “financial lessor’s right” in the section, as appropriate.

4. Recommendation 184 stated clearly that the law should provide for a regime of acquisition security rights in the non-unitary system identical to that adopted in the unitary system. However, in the non-unitary system the law should also provide for a regime of acquisition financing based on retention-of-title arrangements and financial leases. Furthermore, a lender that was an acquisition financier should be able to acquire not only ordinary acquisition financing rights but also the rights of a retention-of-title seller by obtaining an assignment of the obligations owed.

5. The fundamental principle set out in recommendation 185 was that the rights exercised by a retention-of-title seller should be functionally equivalent to those of an acquisition financier.

6. As everything in the unitary approach could be expressed in terms of security rights, any issues that arose could be comprehensively expressed as priority issues. However, in a non-unitary system, retention-of-title sellers retained ownership, so that their relationship with acquisition financiers could not be expressed in terms of priority because the seller’s priority was the natural consequence of its being the owner. It had therefore been decided to recast what was expressed as a priority right in the unitary system as a right that was the consequence of a retention-of-title seller or financial lessor having a right that was effective against third parties.

7. In the unitary system, if an acquisition financier had not fully complied with the requirements to obtain an acquisition financing right and the super-priority attached thereto, the secured creditor would merely lose the super-priority attached to being an acquisition financier but it would retain its other rights. However, in a

non-unitary system where retention of title was an issue, a retention-of-title seller that did not fully comply with the requirements to retain third-party effectiveness of the ownership right would lose its right of ownership to the purchaser. In view of that discrepancy, recommendation 198 had been reformulated to state clearly that if a seller or lessor failed to comply with the requirements for obtaining third-party effectiveness of a retention-of-title or financial lessor's right, the seller or lessor had a security right in the tangible property subject to the sale or lease, and the general regime for security rights applied.

8. **The Chairperson** invited comments on the definitions contained in A/CN.9/XL/CRP.7.

9. **Mr. Macdonald** (Canada), introducing the definitions section, said that the definitions of "acquisition secured creditor" and "acquisition security right" in document A/CN.9/631/Add.1 had been left unchanged. Similarly, the new definition of "financial lessor's right" was broadly the same as the existing definition of "financial lease" and had merely been brought into line with the definition of the term "retention-of-title right". The major change was that the terms "acquisition financing right" and "acquisition financing transferee" were no longer used as generic concepts. Instead, subparagraph (iv) of the former definition of "acquisition financing right" had been inserted at the end of the broadly unchanged definition of "retention-of-title right".

10. In response to a question from **Mr. Kemper** (Germany), he said that the original reason for the drafting of the section of chapter XII on the non-unitary approach to acquisition financing rights had been the desire to address, *inter alia*, the question as to whether retention-of-title arrangements and financial leases were the only types of devices whereby creditors could use ownership in order to secure an obligation. The Working Group had determined that they were not the only devices available for the purpose, but rather than specifying all such devices in each recommendation, it had decided to use the generic term "acquisition financing right" to cover not only retention-of-title arrangements and financial leases but also all other ownership transactions. The Committee therefore had three choices: it could adopt the new generic term; it could retain the primary term "retention-of-

title right", with backing from the "basket clause" in subparagraph (c) of the "Purpose" section at the beginning of chapter XII; or it could decide to recommend in the draft Guide that no other ownership arrangement should be permitted.

11. **Mr. Smith** (United States of America) suggested stating in the commentary that the basket clause had been inserted to cover any additional ownership devices that might exist in particular countries, but that a State in which no such devices existed might wish to omit the basket clause so as to avoid creating a new device.

12. **The Chairperson** pointed out that the definitions themselves were not intended to form part of a piece of legislation or a code but simply to serve as a working glossary for legislators.

13. **Mr. Kemper** (Germany) said that the suggestion by the representative of the United States would certainly reduce the confusion that might be caused by the new definition of "retention-of-title right". It was unclear from the second half of that definition that it related only to a situation in which the creditor had ownership. It was important to avoid extending the retention-of-title right into areas where there might be ambiguity.

14. **The Chairperson** pointed out that the proposal was a restatement of a policy that had already been decided.

15. **Mr. Umarji** (India) said that a clear distinction must be made between a retention-of-title seller that had purchased the asset it was selling with its own funds and a seller that had borrowed funds to obtain the asset. In the latter case, the creditor could obtain assignment of the retention-of-title contract and the situation might be further complicated in the event of non-asset-specific borrowing.

16. **Mr. Bazinas** (Secretariat) said that it had already been agreed as a matter of policy that a lender could obtain what was referred to in the original version of the draft Guide as an "acquisition financing right", a general term that covered the situation referred to by the representative of India. As that general term had been omitted from the proposed new version, the idea of the lender possessing an "acquisition financing right" had been included in the definition of the "retention-of-title right".

17. **Ms. Stanivuković** (Serbia) supported the points made by the representatives of India and Germany. She proposed that the situation of the lender should be omitted from the definition of the retention-of-title right, especially in light of the explicit provision in the proposed new version of recommendation 184 that a lender could acquire the benefit of a retention-of-title right.

18. **Ms. Walsh** (Canada) proposed inserting the word “irrevocably” before “transferred from the seller to the buyer” in the first part of the new definition of “retention-of-title right” to cover a case in which a seller transferred title but reserved the right to recover ownership if the payment obligation was not satisfied.

19. With regard to the aim of the non-unitary approach to enable lenders to obtain retention-of-title rights, it would be difficult in legislation dealing with sale and lease to justify referring to a party that did not have ownership at the outset as retaining ownership. It would therefore be more logical to deal with the matter solely in recommendation 184, which stated that lenders could obtain acquisition security rights through assignment by the seller or lessor. She noted that the redrafting process had been motivated by the concern of some States to preserve the consistency of their legal systems based on retained ownership.

20. **The Chairperson** noted that it had already been decided as a matter of policy that lenders should be able to obtain the rights in question directly as well as by way of an assignment.

21. **Mr. Voulgaris** (Greece) said that the proposal before the Committee accurately reflected the policy decisions already taken. He suggested, however, merging subparagraphs (ii) and (iii) of the definition of the “financial lessor’s right”.

22. **Mr. Riffard** (France) said that the proposed new text clarified the principles and policies that had been developed to date, namely that in the non-unitary system there was a general category of acquisition financing rights with two subcategories. The first subcategory consisted of creditors with a right in tangible property that either retained the title or transferred it subject to payment of the purchase price as well as lenders who obtained the right through assignment of a receivable. That

subcategory was covered both by the definition of a retention-of-title right and by revised recommendation 184. The second subcategory consisted of creditors or lenders that obtained an acquisition security right without retention of title. That subcategory was also covered by revised recommendation 184 as well as by the definition of a “security right” in document A/CN.9/631/Add.1.

23. **Mr. Bazinas** (Secretariat) asked whether revised recommendation 184 was designed to bring about the same result as the definition of a “retention-of-title right” in document A/CN.9/CRP.7. While the second part of the recommendation appeared to suggest that a lender could obtain a retention-of-title right only by assignment of the secured obligation, the second part of the definition seemed to imply that a lender could also obtain such a right directly. The latter approach would be consistent with the understanding reached in earlier discussions of the text approved by the Working Group, an understanding that had been motivated, *inter alia*, by the practical impact on the cost of credit.

24. **Ms. Walsh** (Canada) said that the purpose of the “catch-all” category in the second part of the definition of “retention-of-title right” was to cover situations in which a seller transferred ownership to a buyer subject to the right to recover ownership if the payment obligation was not satisfied. It did not introduce any new concepts and could therefore be deleted, subject to the inclusion of a reference to irrevocable ownership in the first part of the definition.

25. Document A/CN.9/CRP.7 had been drafted on the assumption that assignment would be required for a lender to obtain retention-of-title rights. The original version of the draft Guide did not state that all categories of creditors could obtain acquisition security rights in the non-unitary system. The note to the Commission following recommendation 191 had suggested including a rule whereby creditors could obtain such a right as an alternative to a retention-of-title right. The Committee had acted on that suggestion and, as a result, the non-unitary system now provided for both acquisition security rights and retention-of-title rights, with the limitation that lenders could obtain the latter only by way of assignment. A rule whereby a lender could

obtain retention-of-title rights without ownership of tangible property was likely to prove incompatible with existing property legislation in many jurisdictions.

26. **Mr. Marca Paco** (Bolivia) said that he failed to understand why delegations should be permitted to put forward new proposals that were inconsistent with policies on which the Committee had already agreed.

27. **The Chairperson** reminded the Committee that it had decided to accept the proposal made by the representative of France at its 840th meeting to redraft the recommendations on acquisition financing rights in the non-unitary approach section. Some delegations seemed to view that decision and its outcome as entailing a change of policy, while others disagreed.

28. **Mr. Perezniето Castro** (Mexico) endorsed the proposal contained in document A/CN.9/CRP.7. Rather than introduce new concepts, it reformulated the concepts underlying the original version of recommendation 184. While it was true that the principles were not easily incorporated into civil-law systems, Mexico had already successfully incorporated similar provisions from the Model Inter-American Law on Secured Transactions. His sole reservation concerned the second part of the definition of retention-of-title rights, which needed to be clarified.

The meeting was suspended at 11.10 a.m. and resumed at 11.35 a.m.

29. **Mr. Kemper** (Germany) said that lenders who were not owners of property should be accorded retention-of-title rights only by assignment. That approach was consistent with revised recommendation 184. He wished to be reminded of the exact terms of the earlier decision referred to by the Chairperson.

30. **Mr. Bazinas** (Secretariat) said that the Working Group had decided to provide not only for equal treatment for all acquisition credit providers but also for functional equivalence. Accordingly, lenders, sellers and other acquisition credit providers would be treated equally. Functional equivalence meant that no credit provider should enjoy an advantage that would distort competition and hence have an adverse impact on the availability

or the cost of credit. Furthermore, the Committee had decided that the second paragraph of the note to the Commission following recommendation 191 in the non-unitary approach section should be reflected in the final version of the text. The representative of Canada had expressed the view that it was not the intention of that paragraph to preclude lenders from obtaining acquisition financing rights by means other than assignment.

31. **Mr. Macdonald** (Canada), referring to the definition of an acquisition financing right in document A/CN.9/631/Add.1, said that the first subparagraph was intended to encompass classic retention-of-title transactions; the second subparagraph covered traditional financial leases; the third subparagraph was intended to cover any other clause or technique whereby a seller would use title to secure the performance of an obligation; and the purpose of the fourth subparagraph was to indicate that complete functional equivalence would involve enabling lenders that were not owners of property to acquire a property right directly. The text of the fourth subparagraph had been inserted at the end of the revised version of the definition of a retention-of-title right because that was clearly the place for a transfer of title involving a lender. However, Committee members had obviously not all understood the definition of acquisition financing rights in the same way. Some considered that it encompassed lender title security, while others thought that it did not. As a result, some considered that the proposal contained in document A/CN.9/CRP.7 represented a change of policy, while others disagreed. If the Committee took the view that lenders should not be entitled to acquire a property right directly, the second part of the proposed definition of a retention-of-title right could be deleted.

32. **Ms. Stanivuković** (Serbia) proposed deleting the second part of the definition and inserting the word “irrevocably” in the first part, as proposed by the delegation of Canada.

33. **Mr. Riffard** (France) said that he had construed the word “creditor” in the second part of the retention-of-title definition to mean a seller with a title to tangible property. Clearly, many others had construed it more broadly as permitting a lender to acquire a retention-of-title right directly, which was

not possible in the context of the non-unitary approach. He therefore supported the proposal by the representative of Serbia. It should, however, be borne in mind that a seller could obtain a security right comparable to a retention-of-title right through an agreement that property would revert to it in the event of buyer default. That eventuality was covered by the definition of an acquisition security right but it was not a retention-of-title right.

34. **Mr. Pendón Meléndez** (Spain) expressed support for the deletion of the second part of the definition of a retention-of-title right. While he considered the insertion of the word “irrevocably” unnecessary, he would not object to its inclusion.

35. **Mr. Smith** (United States of America) said that the Commission had already taken a policy decision in support of the principle of functional equivalence. The second part of the proposed definition of a retention-of-title right supported that principle. He noted, for example, that proposed recommendation 199 concerning post-default enforcement in document A/CN.9/XL/CRP.7 seemed to include provisions for retention-of-title sellers that were different from those applicable to holders of security rights — hence the importance of retaining the clause in the definition that supported functional equivalence. Permitting a lender to obtain the rights of a retention-of-title seller was also consistent with the law of countries that provided for such an eventuality by subrogation. He added that the new version of recommendation 184 failed to solve the problem because it required the consent of the seller to the assignment whereby a lender could obtain functional equivalence.

36. **Mr. Umarji** (India) said that in States in which the retention-of-title system was prevalent, it should be possible under the general law for a retention-of-title holder to assign its rights to a lender. In other jurisdictions, secured creditors would be free under the general law to convert their security rights into retention-of-title rights. There was therefore no need for a specific provision in that regard in the draft Guide.

37. **Mr. Kohn** (Observer for the Commercial Finance Association) expressed support for the comments by the representative of the United States. The draft Guide should make it clear that a lender could acquire retention-of-title rights by subrogation

or assignment from a retention-of-title seller, or alternatively that a lender should be able to create acquisition security rights. The remedies available to a lender in respect of acquisition security rights in a non-unitary jurisdiction should be functionally equivalent to those available to a retention-of-title seller. In other words, neither should have an advantage over the other.

38. **Mr. Riffard** (France) said that the proposed amendment to the definition of a retention-of-title right was not intended to undermine the principle of functional equivalence. It was merely intended to ensure consistency by reserving that definition for creditors with a security right based on ownership and dealing with lenders possessing ordinary security rights in the definition of acquisition security rights. Functional equivalence was clearly guaranteed by the revised “Purpose” section, subparagraph (b) of which provided for equal treatment of all providers of acquisition financing. If there was a problem with the proposed new version of recommendation 199, it could be addressed when that recommendation was considered.

39. **Mr. Macdonald** (Canada) proposed revising the new version of recommendation 184 to enable a lender to acquire title rights not only by assignment but also by subrogation, which would not require the seller’s consent. However, it would have to be made clear in the general law of subrogation that the seller’s claim still took precedence.

40. **Ms. Kasule** (Uganda), referring to the draft Guide’s objective of promoting fair competition, suggested examining the potential disadvantages that sellers might suffer if the full text of the right-of-title definition was retained, i.e. if lenders could acquire a right in property not only through assignment but also directly.

41. **Mr. Sigman** (United States of America) said that the element of competition was also absent in the case of an assignment, which required the consent of the seller.

42. If it was important to preserve the distinction between a lender and a seller in the definitions, he was prepared to accept the deletion of the second half of the proposed definition of a retention-of-title right. He supported the proposal by the representative of Canada to insert a provision in the

new version of recommendation 184 or elsewhere enabling a lender to acquire title rights by subrogation. It should further be made clear that an assignment was operable and that it was also possible for a lender to obtain acquisition security rights directly without relying on assignment or subrogation, provided that it had extended credit for the purpose of acquiring possessory use of tangible property.

43. **Ms. Walsh** (Canada) said that there had been a unanimous policy decision to the effect that a transfer of title from a borrower to a creditor could not be treated as vesting ownership in the creditor. She was therefore pleased to note that the representative of the United States was prepared to accept subrogation as an indirect way of achieving retention-of-title status for lenders.

The meeting rose at 12.30 p.m.

**Summary record of the 845th meeting, held at the Vienna International Centre
on Friday, 29 June 2007, at 2 p.m.**

[A/CN.9/SR.845]

Chairman: Ms. Sabo (Chairperson of the Committee of the Whole) (Canada)

The meeting was called to order at 2.05 p.m.

Adoption of a draft UNCITRAL Legislative Guide on Secured Transactions and possible future work (continued) (A/CN.9/617, 620, 631 and Add.1-11, 632 and 633; A/CN.9/XL/CRP.7)

XII: Acquisition financing rights (continued)
(A/CN.9/631)

Section B: Non-unitary approach to acquisition financing rights (recommendations 184 to 201)
(continued)

Terminology and rules of interpretation
(A/CN.9/631/Add.1)

Proposal by the Canadian delegation on acquisition financing (non-unitary approach) (continued)
(A/CN.9/XL/CRP.7)

Definition of a retention-of-title right

1. **The Chairperson** said that, if she heard no objection, she would take it that the Committee wished to adopt the following amended version of the definition of a retention-of-title right in document A/CN.9/XL/CRP.7: “‘Retention-of-title right’, a term used only in the context of a non-unitary approach, means a seller’s right in tangible property, other than negotiable instruments or negotiable documents, pursuant to an agreement with the buyer by which ownership of the tangible property that is the object of the sale is not transferred or not irrevocably transferred from the seller to the buyer until the purchase price is paid.”

2. *The definition of a retention-of-title right, as amended, was adopted.*

3. **The Chairperson** said she also took it that the Committee accepted, as a policy matter, that a lender could acquire rights both through assignment and by subrogation.

4. *It was so decided.*

Definition of a financial lessor’s right

5. **Mr. Bazinas** (Secretariat) suggested replacing the term “financial lessor’s right” by “financial lease right” in order to bring it into line with the term “retention-of-title right”.

6. **The Chairperson** said she took it that, the Committee wished to amend the term itself in the interests of consistency and to adopt the proposed definition.

7. *The definition of a financial lease right was adopted.*

Definitions of an acquisition secured creditor and an acquisition security right.

8. *The definitions of an acquisition secured creditor and an acquisition security right were adopted.*

Proposed new recommendation 184

9. **Mr. Macdonald** (Canada) suggested that the words “or by subrogation” should be added at the end of the last sentence of proposed new recommendation 184.

10. **Mr. Riffard** (France) expressed support for the proposed amendment and suggested that an explanation of subrogation should be included in the commentary.

11. **Ms. Stanivuković** (Serbia) suggested deleting the words “of the obligation owing to the seller or lessor” and ending proposed new recommendation 184 with the words “through an assignment or by subrogation”.

12. **The Chairperson** said that, if she heard no objection, she would take it that the Committee wished to leave the final drafting of the amendment to the Secretariat.

13. *It was so decided.*

14. *Proposed new recommendation 184, as amended, was adopted.*

Proposed new recommendation 185

15. *Proposed new recommendation 185 was adopted.*

Proposed new recommendation 186

16. **Mr. Cohen** (United States of America) asked whether the recommendation that a retention-of-title right and a financial lessor's right must be evidenced in writing "before" the buyer or lessee obtained possession was intended to exclude not only a subsequent writing but also a situation in which the right was evidenced in writing simultaneously with the buyer or lessee obtaining possession.

17. **Mr. Macdonald** (Canada) said he believed that that was the intention. The word "before" had been taken from the original version of recommendation 185.

18. **Mr. Cohen** (United States of America) proposed making it clear that the right must be evidenced in writing before or at the same time as the buyer or lessee obtained possession.

19. **Mr. Macdonald** (Canada) said that the proposal by the representative of the United States was probably what the original recommendation had intended to say. The amendment would also be consistent with the decision already taken regarding acquisition financing rights.

20. **The Chairperson** said, if she heard no objection, she would take it that the Committee wished to amend the recommendation along the lines proposed, leaving the final wording to the Secretariat.

21. *It was so decided.*

22. *Proposed new recommendation 186, as amended, was adopted.*

Proposed new recommendation 187

23. **Mr. Macdonald** (Canada) said that the second sentence of the proposed new recommendation made it clear, albeit inelegantly, that the right of the acquisition or other secured creditor arose

immediately and would therefore be opposable in bankruptcy proceedings.

24. **Mr. Kemper** (Germany) said that the proposed new recommendation implied that a buyer could legally expect to become the owner of a security right. He wondered how that could be deemed to constitute a retention-of-title right.

25. **Ms. Walsh** (Canada) said that the proposed new recommendation did not refer to a retention-of-title right but to a security right. A buyer could create a security right notwithstanding the fact that title had not yet been transferred.

26. **Mr. Bazinas** (Secretariat) said that the proposed new recommendation reflected provisions of German law whereby the buyer had "expectancy of ownership", the value of which was part of the purchase price paid. Such value could be used by the buyer to create a security right, although full legal ownership remained with the seller.

27. **Mr. Kemper** (Germany) wondered whether it was appropriate to refer to such a right during the "expectancy of ownership" period as a retention-of-title right.

28. **Mr. Macdonald** (Canada) said that while the retention-of-title seller retained ownership, the expectancy right in the hands of the purchaser was sufficient to support the granting of a security right but not the acquisition of a retention-of-title right.

29. **Mr. Kohn** (Observer for the Commercial Finance Association) said that the second sentence of proposed new recommendation 187 implied that the security right could not be enforced until the obligation to the seller had been paid in full. He therefore suggested the following alternative wording: "The security right is enforceable only to the extent of the value of the tangible property in excess of the obligation owing to the seller or financial lessor."

30. **Ms. Walsh** (Canada) said that she could support that suggestion because the proposed new recommendation was intended to limit the value of the security right to the value remaining after satisfaction of the obligation owing to the seller and not to dictate the time at which the right could be enforced. As with all the retention-of-title and financial lease rules, there was an implicit priority

rule to the effect that the retention-of-title seller was entitled to first payment from the value of the property and the secured creditor ranked second and received only the excess. In a unitary system that situation would be referred to as priority.

31. **Mr. Sigman** (United States of America) said he agreed that the rule in the proposed new recommendation was not concerned with how or when enforcement took place but merely with the relative priorities. He therefore proposed deleting the reference to enforcement in the second sentence of the proposed new recommendation.

32. **The Chairperson** suggested wording along the following lines: “The security right is limited to the value remaining in the tangible property in excess of the obligation owing to the seller or financial lessor.” The final drafting could be left to the Secretariat. Having heard no objections, she said she took it that the Committee wished to adopt proposed new recommendation 187, as amended.

33. *Proposed new recommendation 187, as amended, was adopted.*

Proposed new recommendation 188

34. **Mr. Kemper** (Germany) asked whether the provision requiring a retention-of-title and a financial lessor’s right in consumer goods to be evidenced in writing was really necessary and whether a retention-of-title right was effective against third parties on the basis of creation.

35. **Mr. Macdonald** (Canada) noted that original recommendation 187, on which proposed new recommendation 188 was based, read: “The law should provide that an acquisition financing right relating to consumer goods is effective against third parties upon its creation.” As “acquisition financing right” had been replaced by “retention-of-title right” and “financial lessor’s right” in the new recommendation, the notion of creation was no longer relevant. What mattered was the time at which the agreement between the parties took place, since that was when the right became effective against third parties. He therefore agreed that there was no need for the reference to a writing.

36. **The Chairperson** suggested deleting the words “by a writing” but retaining the reference to new recommendation 186. Having heard no

objections, she said she took it that the Committee wished to adopt recommendation 188, as amended.

37. *Recommendation 188, as amended, was adopted.*

Proposed new recommendations 189 and 190 (options A and B)

38. **Mr. Macdonald** (Canada) said that proposed new recommendation 190 under both options A and B was based on original recommendation 192. Original recommendation 190, which referred only to consumer goods, had become redundant because its content had been addressed in proposed new recommendation 188, under which retention of title in consumer goods was effective against third parties upon conclusion of the sales contract. Original recommendation 191 had also become redundant because its substance had been addressed in proposed new recommendation 184.

39. **Ms. Stanivuković** (Serbia), supported by **Mr. Macdonald** (Canada), proposed stating in subparagraph (b) of new recommendation 189 under both options that a notice relating to the retention-of-title or financial lessor’s right should be registered in the general security rights registry.

40. **The Chairperson** said that, if she heard no objection, she would take it that the Committee wished to adopt the proposed amendment.

41. *Proposed new recommendations 189 and 190 (options A and B), as amended, were adopted.*

Proposed new recommendation 191

42. *Proposed new recommendation 191 was adopted.*

Proposed new recommendations 192 and 193

43. **Ms. Stanivuković** (Serbia) said that proposed new recommendation 192 belonged under option A because notification of inventory financiers on record was required only under that option. She therefore proposed moving new recommendation 192 so that it followed new recommendation 190 under option A.

44. **Ms. Walsh** (Canada) expressed support for the proposal by the representative of Serbia. She also proposed that the heading of recommendation 192 should be amended to read “One notification

sufficient” and that of recommendation 193 to “One registration sufficient”.

45. **Mr. Riffard** (France) expressed support for the proposal to change the order of the new recommendations. He pointed out that the drafting committee had decided that the term “notification” should be used only in the context of the assignment of receivables. The term “notice” should be used for all other types of written communication. Accordingly, the titles of proposed new recommendations 192 and 193 should read “One notice sufficient” and “One registered notice sufficient” respectively.

46. **The Chairperson** said she took it that the Committee wished to move proposed new recommendation 192 so that it followed new recommendation 190 under option A and to amend the titles of proposed new recommendations 192 and 193 in accordance with the proposal by the representative of France.

47. *It was so decided.*

48. *Proposed new recommendations 192 and 193, as amended, were adopted.*

Proposed new recommendations 194 to 197

49. **Ms. Walsh** (Canada) said that proposed new recommendations 194 to 197 would have to be corrected to take account of the policy decision to offer two options with respect to acquisition financing. Pursuant to that decision, a secured creditor with an acquisition security right in inventory had super-priority with respect to the inventory but not with respect to proceeds in the form of receivables, negotiable instruments or rights to payment of funds credited to a bank account. The current draft implied that a retention-of-title right extended to proceeds in the form of receivables, so that a retention-of-title seller would also have super-priority in the proceeds. The proposed text should be amended to make it clear that there was no retention-of-title right vis-à-vis proceeds from the sale of inventory as against third parties, where the proceeds took the form of money, receivables, negotiable instruments or rights to payment of funds credited to a bank account. A retention-of-title seller in that situation would instead obtain a security right that would be effective against third parties in the

receivables concerned. That would parallel the situation with regard to acquisition security rights, i.e. there would be no super-priority vis-à-vis prior lenders in respect of proceeds of inventory that took the form of liquid assets of that kind.

50. She noted that option A had special rules for acquisition financing relating to inventory proceeds as opposed to proceeds of property other than inventory inasmuch as it required notification of an earlier-registered secured creditor with a security right in proceeds of the same kind. Option B made no such distinction.

51. **Mr. Bazinas** (Secretariat) said he had understood from earlier discussions of priority in respect of proceeds that the separate options for goods subject to retention of title would not be applicable to proceeds, but that two different rules, depending on the type of proceeds, would apply to both option A and option B. A retention-of-title right would extend to proceeds from tangible property other than inventory or consumer goods but it would not extend to proceeds of inventory in the form of the payment rights described in proposed new recommendation 197. Depending on whether a State chose option A or B, the effectiveness of the retention-of-title right would be achieved in different ways

52. **Mr. Macdonald** (Canada) said that it might be useful to specify in the case of proposed new recommendation 197 that the right in question must have been made effective against third parties. He suggested modelling any amendments to the proposed new recommendations on the rule stated in proposed new recommendation 198, which was applicable to a different context.

53. **Mr. Bazinas** (Secretariat) said he took it that the proposal by the Canadian delegation implied that recommendations 195 and 196 would be deleted and that a recommendation would be added after proposed new recommendation 197 to the effect that in the case of proceeds of inventory to which the retention-of-title right did not extend, the retention-of-title seller retained a security right.

54. **Ms. Walsh** (Canada) said that proposed new recommendations 195 and 196 addressed the question of how to achieve third-party effectiveness of the extension of retention-of-title rights to

proceeds. They reflected the rules contained in general recommendations 40 and 41 on achieving third party effectiveness of security rights in chapter V of the draft Guide.

55. **Mr. Rehbein** (Germany) recalled that his delegation had opposed the wording of original recommendations 189 and 192 because of the difficulty of making a clear distinction between inventory and other tangible property. It had therefore been decided to adopt alternative approaches: option A and option B. Under option B no distinction was made between inventory and other property. He was therefore opposed to the distinction made between inventory and other property in proposed new recommendation 194.

56. **Mr. Bazinas** (Secretariat) asked whether it would be acceptable to avoid making a distinction between inventory and goods other than inventory and to make it clear that retention-of-title and financial lease rights did not extend to proceeds.

57. **The Chairperson** said that, if she heard no objections, she would take it that there was no policy disagreement on that point.

58. *It was so decided.*

59. **Mr. Smith** (United States of America) said that most retention-of-title jurisdictions did not permit retention-of-title sellers to have a right in proceeds, and even those that did referred to a security right rather than to a retention-of-title right. The only reason to extend the retention-of-title right to proceeds in the non-unitary approach recommendations would be to maintain the principle of functional equivalence. He therefore suggested that retention-of-title sellers should have a normal security right in proceeds, with the priority rules being those set out in recommendations 198 and 199.

The meeting was suspended at 3.45 p.m. and resumed at 4.15 p.m.

60. **Mr. Bazinas** (Secretariat), summing up the proposals, said that the retention-of-title right would not extend to proceeds in the form of receivables, negotiable instruments, funds credited in a bank account and the obligation to pay under an independent undertaking. The retention-of-title seller would instead have a security right and the general rules applicable to such a right would apply,

namely recommendations 40 and 41 concerning third-party effectiveness of a security right in proceeds.

61. **Mr. Smith** (United States of America) said that his proposal was somewhat different because of the importance he attached to the principle of functional equivalence between the unitary and non-unitary approaches. Under the unitary system, an acquisition secured creditor automatically had a security right in proceeds, even in the form of receivables, money or instruments. To ensure functional equivalence, a similar right should be available to retention-of-title sellers in the non-unitary system. Similarly, a retention-of-right seller should enjoy the same priority for its security right in proceeds as an acquisition financier under the unitary system.

62. **Ms. Walsh** (Canada) said she believed that the delegation of Germany had requested an option B in respect of proceeds that would dispense with any distinction between proceeds from a buyer's resale of equipment and inventory and that would give the seller an ordinary security right in proceeds from either source. That would be slightly different from the situation with respect to acquisition security rights, in which super-priority existed for proceeds from equipment even in the form of receivables.

63. **Mr. Bazinas** (Secretariat) asked for confirmation that retention-of-title rights did not extend to proceeds in the form of the payment rights described in proposed new recommendation 197.

64. **Mr. Smith** (United States of America) said that he would be unable to support a recommendation whereby different rules governing priority in proceeds were applicable to sellers in unitary and non-unitary systems. The principle of functional equivalence demanded that the results under the two systems were identical. Retention-of-title sellers in the non-unitary system should have exactly the same priority as their counterparts in the unitary system.

65. **Mr. Macdonald** (Canada) said he wished to clarify the differences between the proposals before the Committee. He understood that the representative of the United States suggested amending the proposed new recommendations so that they referred to all kinds of proceeds, in which case the retention-of-title seller's right in the

proceeds would not be an ownership right but a security right and the rules governing the existence or non-existence of super-priority in respect of that right would be identical to the rules under the unitary system. He asked for confirmation from the delegation of Germany that it was proposing a proceeds rule that did not distinguish between inventory and property other than inventory, as well as a proceeds right that was an ordinary security right and that never had super-priority.

66. **Mr. Kemper** (Germany) said that he could concede the principle that rights in proceeds from inventory and equipment should be dealt with in the same way.

67. **The Chairperson** said she took it that the Committee wished to ask the Secretariat to redraft proposed new recommendations 194 to 197 in the light of the discussion.

68. *It was so decided.*

Proposed new recommendation 198

69. **Mr. Macdonald** (Canada) said that the rule in proposed new recommendation 198 would be clearer if the words “ownership passes to the buyer or lessee but” were added after “if a seller or lessor fails to comply with the requirements for obtaining third-party effectiveness of a retention-of-title or financial lessor’s right”.

70. **Mr. Kemper** (Germany) said that failure to fulfil the requirements for obtaining third-party effectiveness was essentially an issue involving the retention-of-title seller and other creditors. He was therefore unable to understand why a seller’s failure to meet those requirements should result in the property being transferred to the buyer.

71. **Ms. Walsh** (Canada) said she agreed that ownership could not pass from the seller to the buyer until the purchase price had been paid. The seller’s retention-of-title right would be reduced to the status of a security right solely for the purpose of ascertaining third-party effectiveness. It would therefore be more accurate to state that the buyer was considered to be the owner of the property as against third parties. The proposed new recommendation had been included in order to parallel the acquisition security rights approach. Thus, even though a retention-of-title seller would

no longer have ownership vis-à-vis third parties if it failed to register within the applicable grace period, it would retain a security right.

72. **Mr. Voulgaris** (Greece) proposed amending the final clause of the proposed new recommendation to read “the seller or lessor can have a security right in the tangible property subject to the sale or lease if the general regime for security rights applies”.

73. **Mr. Riffard** (France) said that the retention-of-title arrangement continued to be effective between the parties. However, if the creditor failed to fulfil the requirements for obtaining third-party effectiveness, it bore the traditional consequences. Third parties would be entitled to treat the buyer as the owner, and the seller would be “demoted” to the rank of an ordinary creditor.

74. **Mr. Kemper** (Germany) said that he still had doubts about the need for the proposed new recommendation. Its scope appeared to extend beyond the mere failure to give notice within the prescribed period.

75. **Ms. Walsh** (Canada) said that where a seller in a non-unitary system registered ownership within a specified grace period for the purpose of third-party effectiveness, that ownership would prevail over a prior lender’s registered security right in the buyer’s after-acquired property. If the seller did not register within the grace period, the logical legal consequence was that retained ownership was no longer effective against third parties. In the unitary system, a secured creditor that failed to register lost its super-priority over prior lenders and was left with an ordinary security right. It was thus subordinated to prior lenders but had a security right against other third parties. In order to achieve the same result in a retention-of-title system, in which super-priority was based on retained ownership, that ownership had to be converted into an ordinary security right. The seller would then retain a real right in the asset but would not prevail over prior lenders.

76. **Mr. Riffard** (France) pointed out that an ordinary security right would also have to be registered in order to be effective against third parties.

77. **The Chairperson** asked the delegation of Germany whether its concerns had been met.

78. **Mr. Kemper** (Germany) said that his delegation would not request the deletion of proposed new recommendation 198.

79. **Ms. McCreath** (United Kingdom) suggested that the explanations provided with respect to the recommendation should be added to the commentary.

80. **The Chairperson** said she took it that the Committee wished to amend proposed new recommendation 198 to include a reference to effectiveness against third parties and to clarify that failure to comply with registration formalities would result in the seller or lessor acquiring a security right, which would also have to be registered.

81. *It was so decided.*

82. *Proposed new recommendation 198, as amended, was adopted.*

The meeting rose at 5.00 p.m.

**Summary record of the 846th meeting, held at the Vienna International Centre
on Monday, 2 July 2007, at 9.30 a.m.**

[A/CN.9/SR.846]

Chairman: Ms. Sabo (Chairperson of the Committee of the Whole) (Canada)

The meeting was called to order at 9.40 a.m.

Adoption of a draft UNCITRAL Legislative Guide on Secured Transactions and possible future work (*continued*) (A/CN.9/617, 620, 631 and Add.1-11, 632 and 633; A/CN.9/XL/CRP.4 and 7)

XII: Acquisition financing rights (continued)
(A/CN.9/631)

Section B. Non-unitary approach to acquisition financing rights (recommendations 184 to 201)
(*continued*)

Proposal by the Canadian delegation on acquisition financing (non-unitary approach) (continued)
(A/CN.9/XL/CRP.7)

Proposed new recommendations 199 to 201

1. *Proposed new recommendations 199 to 201 were adopted.*

VII: Priority of a security right as against the rights of competing claimants (continued) (A/CN.9/631)

Recommendation 107 (continued)

2. **Mr. Cohen** (United States of America) said that his delegation proposed the following amended version of recommendation 107:

“The law should provide that a security right in tangible property made effective against third parties by possession of a negotiable document has priority over a competing security right made effective against third parties by another method. This rule does not apply if (i) the tangible property is not inventory and (ii) the security right of the secured creditor not in possession of the negotiable document was made effective against third parties before the earlier of (x), the time that the tangible property became represented by the negotiable document, and (y), the time when an agreement was made between the grantor and the secured creditor in

possession of the negotiable document providing for the tangible property to be represented by a negotiable document, so long as the tangible property became so represented within [30 days] from the date of the agreement.”

3. Both the original version and the amended version of recommendation 107 were intended to deal with a conflict between two legitimate interests: (a) that of a person with a security right in a document, and hence in the goods they represented, that had made the right effective against third parties by taking possession of the document; and (b) that of a person with a security right in the goods that had been made effective against third parties by a method other than the document. The original text had failed to provide for the wide variety of transactions in which such a conflict might arise. The proposed amended version gave substantial protection to a party whose interest was made effective against third parties by possession of a document, but it made an exception in some cases where goods became subject to a security right of at least one of the parties before the goods were represented by a document. For instance, a person that made a security right effective against third parties by registration of a notice prior to the existence of a document had a legitimate interest and the person that was in possession of the document also had a legitimate interest. Where the grantor defaulted and the goods were not valuable enough to satisfy both obligations, the law would have to determine who had priority. The proposed text of the recommendation provided that, where the tangible property was inventory and the secured creditor could have anticipated that the grantor would put the goods into the flow of commerce and that they might therefore be represented by a document, the holder of the document would prevail. Where the tangible property was not inventory and the security

right was made effective before the document was issued, the holder of the document would not prevail. The clause following “(y)” in the text dealt with a situation in which the issuance of a document had been anticipated but was delayed. In such cases too, the security right of the creditor that was not in possession of the document had to be made effective against third parties.

4. **The Chairperson** said that, if she heard no objections, she would take it that the Committee wished to adopt the proposed text.

5. *Recommendation 107, as amended, was adopted.*

6. **Mr. Deschamps** (Canada) said he trusted that the commentary would contain an explanation of the recommendation.

XIII: Private international law

Note following recommendation 202 (continued)

7. **Mr. Deschamps** (Canada) reminded the Committee that it had decided to defer action on the note following recommendation 202 until it had taken a decision on recommendation 107.

8. **Mr. Bazinas** (Secretariat) said that the Committee had agreed in principle that a new recommendation should be added after recommendation 202 to deal with the law applicable to priority conflicts between a secured creditor having possession of a negotiable document and a secured creditor with a perfected security right in the goods.

9. **The Chairperson** said she took it that the Committee agreed to insert a new recommendation along those lines.

10. *It was so decided.*

XI: Insolvency (continued) (A/CN.9/631 and Add.8)

Section A: UNCITRAL Legislative Guide on Insolvency Law: definitions and recommendations

11. **Mr. Bazinas** (Secretariat) said that chapter XI was the result of coordination between Working Group V (Insolvency) and Working Group VI (Security Interests). At its thirty-ninth session, the Commission had decided that the draft Guide would reflect the recommendations of the *UNCITRAL*

Legislative Guide on Insolvency Law (the Insolvency Guide) and would be fully consistent with its provisions. The definitions were set out in the draft Guide in order to facilitate understanding of insolvency terminology. The new recommendations in section B and the commentary to the chapter should be read in the context of the Insolvency Guide. The recommendations highlighted issues relating to secured transactions that had been discussed in the Insolvency Guide but were not the subject of specific recommendations. The commentary to chapter XI drew attention to differences between the two guides, such as the different usage of the terms “security interests” and “security rights”.

12. **Ms. McCreath** (United Kingdom) noted that the Committee might need to reconsider the definition of a “financial contract” in the light of its discussion of financial contracts.

13. **The Chairperson** said that, although the definitions reproduced from the Insolvency Guide were not open to discussion, the Committee might need to establish a different definition for the draft Guide.

14. **Mr. Kemper** (Germany) enquired about the status of the selected recommendations from the Insolvency Guide included in section A of chapter XI.

15. **The Chairperson** said that it had been decided that the most effective way of achieving consistency between the guides on insolvency and on secured transactions would be to incorporate the pertinent Insolvency Guide recommendations in the draft Guide.

16. **Mr. Bazinas** (Secretariat) said that if the draft Guide had simply made a general reference to the Insolvency Guide, legislators would have had to study the entire document to identify issues that were relevant to secured transactions. He noted that the commentary to chapter XI also drew attention to several relevant passages in the commentary to the Insolvency Guide. The recommendations in section B did not introduce new concepts but dealt with the applicability of the principles underlying the Insolvency Guide to secured transaction regimes.

17. **Mr. Kemper** (Germany) suggested inserting a note before the list of recommendations from the

Insolvency Guide emphasizing its non-exhaustive nature.

18. **Ms. Walsh** (Canada) expressed support for that proposal. She suggested presenting the recommendations as a unified text, deleting the original numbering of the Insolvency Guide, referring to those numbers in a footnote, and inserting the following explanatory introductory sentence: “The following recommendations from the *UNCITRAL Legislative Guide on Insolvency Law* are pertinent to secured transactions.” A cohesive presentation of existing and new recommendations dealing with similar subject matter would also be helpful.

19. **Mr. Redmond** (American Bar Association) said that Working Group V and Working Group VI had agreed at their two joint sessions that the inclusion of pertinent recommendations from the Insolvency Guide would greatly assist legislators in understanding the draft Guide. His organization supported draft chapter XI as currently structured. The numbering of the recommendations in section A should be identical to that of the Insolvency Guide to facilitate parallel use of the two documents.

20. **Mr. Burman** (United States of America) rejected the proposal to restructure the recommendations from the Insolvency Guide. Combining the two sets of recommendations would blur the distinction between them and it should be clear from the layout that chapter XI was not simply a restatement of insolvency law.

21. **Mr. Riffard** (France) suggested placing the recommendations from the Insolvency Guide in the introductory section of the commentary to chapter XI. The commentary would then be followed by the new recommendations. He further suggested including a consolidated set of all recommendations as an annex to the draft Guide.

22. **Ms. Walsh** (Canada) suggested moving chapter XI to the end of the draft Guide because the recommendations it contained concerned the enacting State’s insolvency law, whereas all other recommendations concerned secured transactions law.

23. **The Chairperson** said that the Committee’s various proposals regarding the presentation of chapter XI would be discussed in due course.

24. **Ms. McCreath** (United Kingdom), referring to the report of the Working Group on the work of its eleventh session (A/CN.9/617), said that her delegation had suggested at that session that recommendation 63 of the Insolvency Guide be included in the draft Guide.

25. **Ms. Clift** (Secretariat) said that recommendation 63 had not been included in the draft Guide because it did not refer specifically to secured creditors. Some recommendations that had not been selected for inclusion were nevertheless germane to the way in which insolvency regimes operated and concerned all types of creditors. An annex to the Insolvency Guide referred to those recommendations and their specific impact on secured creditors.

26. **Ms. McCreath** (United Kingdom) said that she had suggested including recommendation 63 so that readers of the draft Guide would be aware that the provisions relating to post-commencement finance cited in the draft Guide were not the only ones that existed.

27. **Mr. Smith** (United States of America) expressed support for the proposal by the representative of the United Kingdom.

28. **The Chairperson** said that, if she heard no objection, she would take it that the Committee wished to include recommendation 63 of the Insolvency Guide in chapter XI.

29. *It was so decided.*

Section B. Additional insolvency recommendations of the guide on secured transactions (recommendations 173 to 183)

Recommendation 173

30. *Recommendation 173 was adopted.*

Recommendation 174

31. **Mr. Bazinas** (Secretariat) said that recommendation 174 (non-unitary approach) would have to be amended in the light of the Committee’s decision that the term “acquisition financing right” would be replaced by “retention-of-title right” and “financial lease right” in the context of the non-unitary approach to acquisition financing.

32. *Recommendation 174, as amended, was adopted.*

Recommendations 175 to 180

33. *Recommendations 175 to 180 were adopted.*

Recommendation 181

34. **Mr. Burman** (United States of America) proposed amending recommendation 181 to make it clear that a subordination agreement in insolvency proceedings would be binding on the debtor only to the extent that it was effective under law other than insolvency law.

35. *Recommendation 181, as amended, was adopted.*

Recommendations 182 and 183

36. *Recommendations 182 and 183 were adopted.*

The meeting was suspended from 11 a.m. and resumed at 11.30 a.m.

Commentary to chapter XI: Insolvency (A/CN.9/631/Add.8)

37. **Mr. Bazinas** (Secretariat) noted that the introduction to the commentary referred the reader to the recommendations of the Insolvency Guide and the commentary thereto. The new recommendations in the draft Guide would follow the commentary to chapter XI.

Paragraphs 1 to 15

38. **Mr. Redmond** (Observer for the American Bar Association) suggested that the commentary should refer more clearly to relevant recommendations and discuss additional recommendations of the Insolvency Guide. He further suggested that section 4 entitled “Applicable law in insolvency proceedings” (paras. 11-15) should be moved for greater clarity to the end of the commentary, i.e. to just before the new recommendations.

39. **The Chairperson** said that, if she heard no objection, she would take it that the Committee wished to act on the suggestions made by the observer for the American Bar Association.

40. *It was so decided.*

41. *The substance of paragraphs 1 to 15 was approved on that understanding.*

Paragraphs 61 to 76

42. *The substance of paragraphs 16 to 76 was approved.*

43. *The substance of the commentary to chapter XI as a whole was approved, subject to the agreed amendments.*

Coordination with the preliminary draft Unidroit Model Law on Leasing (A/CN.9/XL/CRP.4)

44. **Mr. Bazinas** (Secretariat) drew attention to the comments by the International Institute for the Unification of Private Law (Unidroit) contained in document A/CN.9/XL/CRP.4. He expressed appreciation of Unidroit coordination with UNCITRAL on the drafting of definitions of the terms “acquisition financing right”, “financial lease”, “retention-of-title right” and “security right”.

45. The participants in the forthcoming UNCITRAL Congress on Modern Law for Global Commerce would have the opportunity to hear how cooperation between UNCITRAL, Unidroit and other bodies had contributed to the development of comprehensive guidance for States that wished to improve their secured transactions laws.

46. **Mr. Kronke** (Secretary-General of Unidroit) said that the draft Guide and the preliminary draft Unidroit Model Law on Leasing (the draft Model Law) were part of an effort that had begun in the 1970s to harmonize legislation on secured transactions, including through the drafting of a model law. However, the standardization effort had proved too ambitious at the time and a number of different instruments had been drawn up instead: the 1988 Convention on International Financial Leasing; the 2001 Convention on International Interests in Mobile Equipment (the Cape Town Convention) and its protocols; and the 2001 United Nations Convention on the Assignment of Receivables in International Trade. The current draft Guide was intended to draw all those instruments together.

47. The elements of a joint proposal regarding the relationship between the draft Model Law and the draft Guide had been worked out at a meeting

in 2006 between representatives of UNCITRAL, Unidroit and the Hague Conference on Private International Law. First, the draft Model Law had to clarify that a leasing contract that created a security right or an acquisition financing right was to be treated as a security right, which would not come within the scope of the draft Model Law. Second, the definition of an “acquisition security right” was to be reviewed to reflect the fact that not all “financial leases” created security rights. Third, the draft Model Law would defer for that definition to the draft Guide. Fourth, it was unnecessary to include applicable law provisions in the draft Model Law since that issue would be dealt with in the draft Guide. Fifth, article 3 of the draft Model Law would be expanded to illustrate how and why there were States in which the law implementing the draft Guide was applicable to certain types of leasing transactions. The joint proposal had been endorsed by the Unidroit Committee of Governmental Experts.

48. **Mr. Bazinas** (Secretariat) noted that account would have to be taken of the Committee’s decision to replace the term “acquisition security right” by “retention-of-title right” and “financial lease right”. He also suggested that the commentary should explain that the term “financial lease right” had been defined to ensure that only financial leases that created a security right would be covered by the draft Guide.

49. **The Chairperson** said she took it that the Committee wished to endorse the proposed coordinated approach.

50. *It was so decided.*

Future work on the draft Guide

51. **The Chairperson** asked the Secretariat to inform the Committee about the extent of the work that remained to be done.

52. **Mr. Bazinas** (Secretariat) said that chapters I to VI of the draft Guide (A/CN.9/631 and Add.1 to 3) remained to be discussed. With regard to chapters VII to XIV, a further review might be necessary of recommendations 194 to 197 on the extension of a retention-of-title right or a financial lease right to proceeds (non-unitary approach) and of the commentary on the options pertaining to

recommendations 189 and 192 on the third-party effectiveness of a retention-of-title right or a financial lease right to proceeds (unitary and non-unitary approaches). He referred to the possibility of convening a resumed session of the Commission in December 2007.

53. **The Chairperson** asked whether the Committee had any objections to the convening of a renewed session.

54. **Mr. Burman** (United States of America), supported by **Mr. Kemper** (Germany), said that he would welcome the holding of a resumed session, adding that it would be helpful if delegations could receive the revised versions of the chapters that had already been adopted as soon as possible.

55. **The Chairperson** said she took it that the Committee wished to recommend to the Commission that a resumed session be held from 10 to 14 December 2007 in order to complete the review and approval of the draft Guide.

56. *It was so decided.*

The meeting rose at 12.30 p.m.

**Summary record of the 847th meeting, held at the Vienna International Centre
on Monday, 2 July 2007, at 2 p.m.**

[A/CN.9/SR.847]

Chairman: Ms. Sabo (Chairperson of the Committee of the Whole) (Canada)

The meeting was called to order at 2.10 p.m.

Adoption of a draft UNCITRAL Legislative Guide on Secured Transactions and possible future work (*continued*) (A/CN.9/617, 620, 631 and Add. 1-11, 632 and 633; A/CN.9/XL/CRP.3, 4 and 5)

Future work on security rights in intellectual property (A/CN.9/631 and 632; A/CN.9/XL/CRP.3)

1. **The Chairperson** invited the Committee to consider the question of the treatment of intellectual property in recommendation 4 (b) of the draft Guide (A/CN.9/631) in the light of documents A/CN.9/632 and A/CN.9/XL/CRP.3.

2. **Mr. Bazinas** (Secretariat) said that recommendation 4 (b) reflected the Working Group's approach to security interests in intellectual property, namely that the draft Guide should apply in general to such interests, but that, in the event of inconsistencies between secured transactions law as recommended by the draft Guide and national law or international treaties pertaining to intellectual property, the latter should prevail. The commentary broadly explained how such a deferral to national law or international treaties would work and also noted that States might need to review their internal law to ensure consistency between secured transactions law and intellectual property law. The commentary could also include a reference to future work by the Commission with respect to intellectual property.

3. He noted that the Working Group had not reached agreement on the text in square brackets in recommendation 4 (b), which read "and the matters covered by this law are addressed in that national law or international agreement" and which had been added as a suggestion to the Commission aimed at bringing recommendation 4 (b) into line with recommendation 4 (a).

4. Document A/CN.9/XL/CRP.3 reflected the decisions reached by the Working Group regarding matters that should be clarified in the commentary to the draft Guide.

5. Document A/CN.9/632 suggested possible future work on security rights in intellectual property aimed at promoting effective implementation of the draft Guide in that area.

6. **Mr. Lawrence** (Observer for the Independent Film and Television Alliance) said that the intellectual property community in the United States would support the deletion of the text in square brackets because it unnecessarily limited the scope of the exclusion.

7. **The Chairperson** said that, if she heard no objection, she would take it that the Committee wished to adopt recommendation 4 (b) without the text in square brackets.

8. *It was so decided.*

9. *Recommendation 4 (b), as amended, was adopted.*

10. **The Chairperson** invited the Committee to consider document A/CN.9/XL/CRP.3 concerning additions to the commentary to various parts of the draft Guide that had a bearing on intellectual property.

11. **Mr. Smith** (United States of America) said that the second sentence of section 1 (f) concerning an addition to the commentary to chapter X on post-default rights went well beyond intellectual property rights when it stated that the rule in the first sentence, namely that the secured creditor could only enforce the grantor's right in the encumbered asset, was not intended to override restrictions on the grantor's right to sell or otherwise dispose of, lease or license an encumbered asset. It suggested that a secured creditor was bound by contractual restrictions relating to the encumbered asset which

might have nothing to do with intellectual property rights. He therefore suggested that the first sentence should read as follows: "The secured creditor may only enforce the secured creditor's security right to the extent of the grantor's rights in the encumbered asset." The second sentence would then be deleted and the rest of the paragraph would remain in its current form.

12. **The Chairperson** said that, if she heard no objection, she would take it that the Committee agreed to the proposed amendment.

13. *The substance of section 1 (f) was approved, subject to the agreed amendment.*

14. **The Chairperson** said she took it that the Committee wished to add the content of document A/CN.9/XL/CRP.3, as amended, to the commentaries to the draft Guide.

15. *It was so decided.*

16. **The Chairperson** invited the Committee to consider document A/CN.9/632 concerning possible future work on security rights in intellectual property. While it had been agreed that the finalization of the draft Guide should not be delayed in order to deal with the specificities of intellectual property, it would be appropriate for the Committee to agree on an appropriate course of action.

17. **Mr. Bazinas** (Secretariat) said that document A/CN.9/632 was largely based on suggestions made at the Colloquium on Security Interests in Intellectual Property Rights prepared in cooperation with the World Intellectual Property Organization (WIPO) and held in Vienna on 18 and 19 January 2007.

18. **The Chairperson** said that the Committee was grateful to the representatives of WIPO and other experts from the intellectual property community for the quality of the materials before it.

19. **Mr. Goodger** (Observer for the Association of European Trade Mark Owners) said that his organization supported the draft Guide and its aims. He noted, however, that, given the critical importance of intellectual property in the modern economy, it was essential for issues pertaining to the securitization of intellectual property assets to be dealt with in a separate annex to the draft Guide. Such an annex should be submitted for adoption as

soon as possible and the draft Guide should contain an explicit reference thereto.

20. **Ms. Longcroft** (Observer for the World Intellectual Property Organization), noting the unprecedented importance of intellectual property in the commercial sphere and the recognized inconsistencies between the draft Guide, on the one hand, and existing national law and international treaties pertaining to intellectual property, on the other, said that further work on asset-specific recommendations relating to intellectual property should be undertaken as soon as possible to avoid sending the wrong message to States and lenders about the feasibility and desirability of lending on the basis of intellectual property. A rapid timetable for such work would also ensure that intellectual property considerations and proposed adjustments to the recommendations were placed before all member States of the Commission when they received the finalized text of the draft Guide. She further suggested that States should be invited to include representatives from intellectual property ministries in future discussions of the Working Group.

21. **Mr. Agthe** (Observer for the International Trademark Association) expressed strong support for the idea of an annex to the draft Guide. Work on the annex should proceed as rapidly as possible and the draft Guide should contain a specific reference thereto.

22. **Mr. Rivers** (Observer for the Association of Commercial Television in Europe) said that intellectual property and the need for external finance were extremely important matters for the television companies represented by his organization, which had taken a keen interest in the Commission's work. His organization would also be more than willing to contribute its expertise to any future work on security rights in intellectual property, which he trusted would be carried out as soon as possible.

23. **Mr. Lawrence** (Observer for the Independent Film and Television Alliance) expressed appreciation of the Commission's concern to ensure that the views of all interested parties were sought and heard. At the UNCITRAL Colloquium held in January 2007, he had been encouraged by the Commission's flexibility in considering aspects of

intellectual property that were difficult to reconcile with the current text of the draft Guide. His organization agreed with the comment by the European Community and its member States in document A/CN.9/633 that further work was required on security interests in intellectual property. It supported the proposal to finalize the remainder of the draft Guide and to supplement it with an annex on intellectual property in due course. He cautioned against any overlap between the draft Guide and the drafting work being carried out by the International Institute for the Unification of Private Law (Unidroit). As acknowledged by the Commission, the draft Guide's primary focus was on core commercial assets such as commercial property, inventory and equipment, and trade receivables.

24. As an example of the need for further in-depth discussion, he noted that in the context of intellectual property even the word "receivables" had a very different meaning. It did not mean direct payment for goods stocked or purchased, but ongoing income from licence distribution on behalf of intellectual property rights holders by third parties with a shared interest in earnings, although they did not have ownership of the intellectual property contained in distributed goods. Future work should also provide the opportunity to further differentiate between application to patents, trademarks, copyright and related rights.

25. His organization stood ready to contribute its commercial expertise to future work and hoped that recommendations could be submitted to Working Group VI by May 2008.

26. **Mr. Cohen** (United States of America) expressed broad support for the plan for future work set out in document A/CN.9/632.

27. **Mr. Bazinas** (Secretariat), replying to a question by **Mr. Wezenbeek** (Observer for the European Union), said that it had become clear during the Committee's discussion not only of intellectual property issues but also of securities and financial contracts that a compromise would have to be reached between the desirable and the feasible. Several delegations had stressed that further delays in issuing the draft Guide would reduce its usefulness. He therefore took it that the Committee wished to complete its work on the draft Guide at

the current session and to address questions pertaining to intellectual property, securities and financial contracts at a later date.

28. **Mr. Riffard** (France) expressed support for the suggestion that the current version of the draft Guide should be adopted at the resumed session in December 2007 and that supplementary work should begin thereafter on an annex dealing with intellectual property and possibly also securities and financial contracts.

29. **Mr. Markus** (Switzerland) also expressed support for the programme just outlined. He hoped that work on security rights in intellectual property could begin as soon as the draft Guide had been finalized. Moreover, it should be understood that the text of the future annex on intellectual property would prevail if there were any inconsistencies between it and the text of the draft Guide.

30. **The Chairperson** said that there would be no inconsistencies because the Committee had already adopted recommendation 4 (b), which stated that national law and international treaties would prevail over the draft Guide in the event of inconsistencies, and also because the asset-specific recommendations of the draft Guide would be applicable.

31. **Mr. Voulgaris** (Greece) said that he supported the proposed programme provided that account was taken of work being conducted in the same area by other international and regional organizations.

32. **The Chairperson** pointed out that UNCITRAL was an international forum that must adopt solutions suited to a global context.

33. She said she took it that the Committee wished to suggest to the Commission that, following the adoption of the draft Guide, it should entrust Working Group VI with the task of preparing an asset-specific text on security rights in intellectual property as an annex thereto. If the Commission agreed, it would be useful to insert a reference to the future annex in the draft Guide. The Working Group should be guided by document A/CN.9/623 and take into account relevant work currently being conducted by other international organizations.

34. *It was so decided.*

*Securities and financial contracts**(a) Securities (A/CN.9/631; A/CN.9/XL/CRP.4 and 5)*

35. **Mr. Bazinas** (Secretariat) drew attention to recommendation 4 (c) of the draft Guide (A/CN.9/631), most of which was in square brackets. In the Secretariat's note following recommendation 4 (c), the Commission was invited to consider whether all types of securities should be excluded from the draft Guide or only intermediated securities as defined in the preliminary draft Unidroit Convention on Substantive Rules regarding Intermediated Securities (the draft Convention). Section II of document A/CN.9/XL/CRP.4 contained comments and suggestions by Unidroit on the matter. Document A/CN.9/XL/CRP.5 contained a proposal by the Commercial Finance Association regarding the treatment of securities in the draft Guide or in its future work on the subject.

36. **Mr. Kronke** (International Institute for the Unification of Private Law) said that efforts at an early stage in the process of coordination between Unidroit and UNCITRAL to develop a clear-cut definition of intermediated securities had failed. UNCITRAL's Working Group VI had therefore contemplated an outright exclusion of securities because such a complex issue encompassing several different branches of law would overburden its proceedings. Unidroit's Committee of Governmental Experts, which was currently preparing the draft Convention, had decided at its first session to use the term "indirectly held securities", i.e. securities that were not held by the ultimate investor directly but through various layers of intermediaries. However, it had subsequently discovered that the term was an inadequate description of many of the holding patterns that the draft Convention should address. For example, the Nordic countries, Spain, Brazil, Colombia, China and Malaysia had developed what were known as "transparent systems", in which the central securities depository kept securities accounts for identified investors and knew what kinds of transactions were taking place. Such hybrid holding patterns had been satisfactorily taken into account in the current version of the draft Convention.

37. The Committee of Governmental Experts had considered at its last session the question of whether some systems that might not be indirect holding

patterns should be covered by the draft Guide. The consensus at the end of the session, at which the UNCITRAL Secretariat had been represented, was that there had been good reasons for excluding securities from the scope of the draft Guide in the early stages of the Working Group's proceedings and that additional research was required, for instance on repurchase agreements and certain intra-group transactions. It would also be necessary to test proposals and models against real-life cases and operational market customs.

38. He assured the Committee that Unidroit would be happy to participate in any further discussions of how to proceed on all those fronts.

39. **Mr. Kohn** (Commercial Finance Association) said that his organization wished to recharacterize its proposal contained in document A/CN.9/XL/CRP.5 as a request for future work by the Commission. The categories of securities and transactions described in the document were extremely important in that they made secured credit available to privately held companies with just a few shareholders and perhaps one or more wholly owned subsidiaries. The companies' securities were not traded on any recognized market but played an important role as non-intermediated securities in many kinds of financing transactions, for instance where insufficient other assets in the form of inventory, receivables or equipment existed to justify requested financing, or where the application of financial assistance or corporate governance laws or tax considerations made it impossible for the companies to obtain financing based on their other assets. His organization considered that including non-intermediated securities of that type within the scope of the draft Guide would greatly promote credit for many companies in a large number of countries. However, as it recognized that certain issues needed to be fully aired and understood before the Commission could take a decision, it urged the Committee to recommend that those issues be made the subject of future work.

40. **Mr. Burman** (United States of America) said that although he would have preferred to address more aspects of securities transactions in the main body of the draft Guide, he had been won over by the concerns expressed regarding the risk of failing

to complete the Commission's work on a timely basis. He was now in favour of a broad exclusion.

41. He questioned the use of the term "intermediated", since it was now clear that the Unidroit draft Convention would deal with some aspects of non-intermediated interests. He had similar reservations regarding the term "securities" as defined in the draft Convention. There was strong support for future Commission work on the appropriate scope of coverage of the securities field, including the transactions mentioned by the observer for the Commercial Finance Association. Recommendation 4 (c) should therefore be left open, providing for the exclusion of whatever was covered by the Unidroit draft Convention and for the incorporation of material included in an annex to the draft Guide.

42. **Mr. Kemper** (Germany) said he was in favour of a broad exclusion of securities. Moreover, he felt that any decision on the future work of the Commission should be postponed until the resumed session in December 2007. However, he would not oppose the insertion of a reference in the version of the draft Guide adopted at that session to the possibility of more precise rules being drafted later on to deal, *inter alia*, with certain kinds of securities.

43. **Mr. Voulgaris** (Greece) expressed support for a broad exclusion of both intermediated and non-intermediated securities, since inclusion of the latter might lead to confusion.

44. **Ms. Perkins** (United Kingdom) expressed support for a general exclusion of securities. She also sounded a note of caution regarding any work that might be undertaken on securities. As long as the definition of "intermediated" remained unsettled, the concept of "non-intermediated securities" would also remain unclear and it would be odd to develop rules governing an asset that could not be identified. Second, if both Unidroit and UNCITRAL undertook work on securities, the outcome should not involve the application of wholly different regimes to matters that were essentially unitary in terms of the underlying concept. Third, any carve-out for intermediated and tradable securities contemplated in future work would leave a gap around tradable non-intermediated securities.

45. The areas on which future work should focus were: (a) revision of the early definitions and scoping sections of the draft Guide to make it clear that the legal form of title transfer arrangements in relation to securities was preserved; (b) a hard look at the registration provisions to determine whether they should apply at all to securities; (c) consideration of the asset-specific provisions on possession, since possession was an inappropriate concept and it would probably be necessary to develop a concept of control instead; and (d) a hard look at the conflicts rule. Although the conflicts rule in recommendation 204 would presumably be applicable by default, her delegation's views on the application of that recommendation to financial contracts and securities was well known.

46. **Mr. Deschamps** (Canada) said he believed that, whatever decision was taken about complete or partial exclusion and about future work, the rules on intermediated securities should be integrated into and made conceptually consistent with the rules on non-intermediated securities. For instance, he failed to see how title transfer could be admitted as a security device for intermediated securities if it was not admitted for non-intermediated securities, or vice versa. The anomaly seemed even greater in light of the fact that the distinction between intermediated securities and non-intermediated securities was not obvious and that directly held securities might also be viewed as intermediated securities.

47. **Mr. Branciforte** (Italy) expressed support for the general exclusion of securities.

48. **The Chairperson** said that, if she heard no objection, she would take it that the Committee agreed that all types of securities should be excluded from the draft Guide and that UNCITRAL should develop as part of its future work an annex to the draft Guide that would address certain types of securities, including, *inter alia*, certain non-intermediated and non-traded securities. She also took it that the Committee wished to leave it to the Secretariat to make the necessary changes to recommendation 4 (c).

49. *It was so decided.*

(b) Financial contracts

50. **The Chairperson** said she believed that, with the broad exclusion of securities, a number of issues pertaining to financial contracts had been resolved.

51. **Mr. Burman** (United States of America) expressed support for a broad exclusion of financial contracts.

52. **Mr. Smith** (United States of America) noted that article 4 (2)(b) of the United Nations Convention on the Assignment of Receivables in International Trade (United Nations Assignment Convention) excluded financial contracts governed by netting agreements, except a receivable owed on the termination of all outstanding transactions. Article 4 (2)(c) also excluded foreign exchange contracts, which should likewise be excluded from the draft Guide. If the Committee decided to exclude financial contracts, he proposed that they be considered for future work at the same time as securities.

53. **Mr. Murray** (United Kingdom) said that he would support the exclusion of financial contracts from the scope of the draft Guide. If any further work was undertaken on the subject, a number of points, such as terminology, should be addressed. By any normal commercial understanding of the term “financial contract”, a foreign exchange contract belonged within the scope of the definition. Hence, although the definitions in the Assignment Convention might be perceived as a logical starting point, they were not necessarily appropriate for the Commission’s work on an annex to the draft Guide, given the different purposes of the two instruments and their different focus. Similarly, limiting the exclusion to financial contracts that were subject to netting agreements made sense in the context of the Assignment Convention but not necessarily in the context of the draft Guide because of its different policy, purpose and scope.

54. **Mr. Deschamps** (Canada) expressed support for the proposal by the delegation of the United States. The policy considerations that applied when the Assignment Convention was being drafted were also applicable to the draft Guide. Moreover, the Assignment Convention dealt with security interests in receivables.

55. **Mr. Kemper** (Germany) expressed support for the exclusion of financial contracts. He pointed out that the recently adopted UNCITRAL Legislative Guide on Insolvency Law contained a definition of “financial contract”, which could serve as a guideline for the scope of the exclusion.

56. **The Chairperson** noted that the latter definition was consistent with that in the Assignment Convention.

57. **Ms. Perkins** (United Kingdom) said that although her delegation felt that a different definition of “financial contract” might now be more appropriate, it would not be opposed to a carve-out of financial contracts as defined by the Assignments Convention. She further suggested a carve-out of derivatives and similar transactions that were not supported by a netting agreement and, lastly, a carve-out of foreign exchange transactions, especially spot foreign exchange agreements.

58. **Ms. Walsh** (Canada) pointed out that financial contracts, derivative contracts and foreign exchange transactions were not items of property that could be the subject of an assignment or the creation of a security right. Rather, as recognized by the Assignment Convention, it was the obligations that arose under such transactions that constituted the asset that became the subject of an assignment or a grant of security. It would be helpful if the representatives proposing a broader exclusion than that in the Assignment Convention could explain what their policy objection was to applying the general rules of the draft Guide to a receivable owed on the termination of all outstanding transactions.

59. **Mr. Bazinas** (Secretariat) noted that the draft report already reflected the Committee’s agreement at the current session that references to financial contracts in the draft Guide denoted contingent payment rights that might arise under a financial contract. He suggested that the Committee might wish to focus on the two outstanding issues: (a) whether derivatives and similar instruments that were not supported by a netting agreement might be excluded; and (b) the treatment of receivables owed on the termination of all outstanding transactions.

60. **Mr. Murray** (United Kingdom) said that the definition of financial contract in the Assignment Convention covered both derivatives and similar

contracts that were subject to a netting agreement and those that were not subject to such an agreement. Article 4 (2)(b) of the Convention had excluded financial contracts governed by netting agreements largely because its anti-assignment clauses would potentially disrupt netting arrangements.

61. Different issues arose, however, when it came to creating a security right in that type of intangible property. His delegation therefore felt that financial contracts in general, and not just those subject to a netting agreement, should be excluded for the time being and studied separately. In his practical experience, security was created on a daily basis in financial contracts, some of which were subject to a netting agreement, in financial exchange contracts and in the receivable owed on close-out of all transactions. It was therefore clearly necessary to seek an appropriate means of ensuring third-party effectiveness of that type of security, for instance through registration or control. A separate question was that of the applicable law.

62. He would therefore prefer to start out with the general definition of financial contracts in article 5 of the Assignment Convention and to expand that definition to cover foreign exchange transactions.

63. **Mr. Smith** (United States of America) said that he was opposed to an exclusion that went beyond that set out in the Assignment Convention. He agreed that the primary concern that had led to the exclusion of financial contracts was the protection of netting arrangements. However, where a single receivable was owing, whether it arose from close-out netting or under a single financial contract, the policy relating to the assignment of that receivable was exactly the same as the policy relating to the sale of goods or the provision of services.

64. **Mr. Murray** (United Kingdom) said that, notwithstanding that clarification, he felt that it was potentially unhelpful to focus on the Assignment Convention policy. It was preferable to examine the policy issues that arose, particularly third-party effectiveness, when a variety of financial receivables were included within the scope of the draft Guide.

65. **The Chairperson** said that, if she heard no objection, she would take it that the Committee agreed to apply the definitions used and the approach adopted in article 4 (2)(b) and (c) and article 5 (k) and (l) of the Assignment Convention.

66. *It was so decided.*

67. **Ms. Perkins** (United Kingdom) suggested that interested experts might look into the scope of the exclusion in the context of preparatory work for the resumed session in December.

68. **Mr. Bazinas** (Secretariat) requested guidance as to what was expected of the Secretariat in that regard. Was it expected to draft a recommendation to the effect that security rights in payment rights arising under financial contracts were perfected or made effective against third parties by control or by control and registration? A second recommendation might state that a security right perfected by control would have priority, and a third recommendation might deal with the law applicable to the security right.

69. **Mr. Kemper** (Germany), noting that the delegation of the United Kingdom clearly had a strong interest in widening the scope of the exclusion, proposed that the issue should be left open so that delegations could look into the matter in greater detail prior to the resumed December session.

70. **Ms. Perkins** (United Kingdom) said that she was arguing for a wide exclusion so that future work could be undertaken with all due care and attention. She noted that the Committee had in effect just decided, by adopting the approach set out in article 4 (2)(c) of the Assignment Convention, to exclude foreign exchange transactions.

71. Although the Committee had agreed not to reopen the applicable law rule contained in recommendation 204, it now seemed about to do so. It had also agreed not to overload the draft Guide with sophisticated treatment of complicated instruments. Yet that was precisely what it was doing.

72. **Mr. Deschamps** (Canada) said that, as he saw it, the only difference of opinion related to a very narrow type of receivable, namely the net amount payable on termination where a financial contract

contained a netting agreement. That kind of receivable was covered by the Assignment Convention and the question was whether it should be excluded from the draft Guide. He agreed with the suggestion that the issue might be resolved by exploring whether special rules governing third-party effectiveness and priority should be applicable to such receivables. The Assignment Convention left those matters to applicable law, namely the law of the location of the assignor. The question arose whether the Commission could propose a conflict rule that was different from the one applicable under the Assignment Convention to that type of receivable.

73. **Ms. Kaller** (Austria) said she agreed that all types of financial contracts mentioned by the representatives of the United Kingdom should be carved out from the draft Guide because it might be risky to introduce modifications that delegations had not had sufficient time to examine.

74. **Mr. Smith** (United States of America) said that he would not be in favour of future work that would produce an applicable law rule that was inconsistent with that contained in the Assignment Convention. However, he would be willing to explore, prior to the resumed session in December 2007, other possible adjustments to receivables arising from close-out netting or from a single financial contract, provided that they were compatible with the rules in the Assignment Convention.

75. **Mr. Wezenbeek** (Observer for the European Union) said that he agreed with the representative of Austria that more time was required to ponder the implications of the matters under discussion. He took issue with the argument that the provisions of the Assignment Convention were set in stone. In the real world things evolved and new developments had to be accommodated. Future work should not consist solely in elaborating on what had already been decided.

76. **The Chairperson**, summing up the discussion, noted that the Committee had agreed to adopt the approach to financial contracts set out in the Assignment Convention, not only to ensure consistency with that Convention and the UNCITRAL Legislative Guide on Insolvency Law but also because the same policy considerations applied in the context of the draft Guide.

77. She invited the delegation of the United Kingdom to draw up proposals to deal with third-party effectiveness and priority for submission to the Committee at the resumed session in December. The proposals should be made available ten weeks in advance so that they could be translated into all working languages.

78. **Ms. McGrath** (United Kingdom) said that her delegation would be pleased to act on that suggestion.

79. **The Chairperson** said that, if she heard no objection, she would take it that the Committee agreed that the question of future work on financial contracts after adoption of the draft Guide should be raised with the Commission in due course.

80. *It was so decided.*

Presentation of the draft Guide

81. **The Chairperson** said that, if she heard no objection, she would take it that the Committee agreed that each chapter of the draft Guide would consist of a commentary followed by recommendations, and that the final chapter would be followed by a consolidated set of recommendations and a terminology list.

82. *It was so decided.*

83. **The Chairperson** said that, if she heard no objection, she would take it that the Committee agreed to move chapter XI on insolvency so that it became the last chapter of the draft Guide, the reason being that all the recommendations it contained involved legislation other than secured transactions legislation.

84. *It was so decided.*

The meeting rose at 5 p.m.

**Summary record of the 853rd meeting, held at the Vienna International Centre
on Friday, 6 July 2007, at 10 a.m.**

[A/CN.9/SR.853]

Chairman: Mr. Mitrović (Serbia)

The meeting was called to order at 10.05 a.m.

Adoption of the report of the Commission

(A/CN.9/XL/CRP.1/Add.1-21)

The discussion covered in the summary record began at 10.15 a.m.

III: Adoption of a draft UNCITRAL Legislative Guide on Secured Transactions and possible future work (A/CN.9/XL/CRP.1/Add.1-6)

A. Adoption of a draft UNCITRAL Legislative Guide on Secured Transactions (A/CN.9/XL/CRP.1/Add.1)

1. **Ms. Sabo** (Canada) proposed inserting the following sentence at the end of paragraph 1: “The Committee expressed its great appreciation to the Secretariat for its work in preparing the materials.”

2. **The Chairman** suggested replacing “great appreciation” by “special appreciation” because otherwise the same sentence would have to be inserted in each section of the draft report.

3. *It was so decided.*

1. Chapter VII: Priority of a security right as against the rights of competing claimants

(a) Recommendations (A/CN.9/631, recommendations 74-107) and (b) Commentary (A/CN.9/631/Add.4)

4. **Mr. Bazinas** (Secretariat) suggested moving the words “from a consumer to a consumer” in the third sentence of paragraph 5 to immediately after the words “in a sale” so that the phrase would read: “in a sale from a consumer to a consumer of assets encumbered by a security right”.

5. *It was so decided.*

6. **Mr. Bazinas** (Secretariat) suggested deleting the reference “definition (eee)” from paragraph 6.

7. *It was so decided.*

8. **Mr. Bazinas** (Secretariat) suggested inserting a reference at the end of paragraph 7 to the discussion on securities and financial contracts summarized in paragraphs 17 to 22 of document A/CN.9/XL/CRP.1/Add.4 and in paragraphs 16 to 22 of document A/CN.9/XL/CRP.1/Add.6.

9. *It was so decided.*

10. **Mr. Bazinas** (Secretariat) suggested inserting the word “priority” before “conflict” in the fourth sentence of paragraph 11.

11. *It was so decided.*

12. **Mr. Bazinas** (Secretariat) suggested inserting a reference to paragraphs 3 to 6 of document A/CN.9/XL/CRP.1/Add.6 at the end of paragraph 12.

13. *It was so decided.*

14. *Document A/CN.9/XL/CRP.1/Add.1, as amended, was adopted.*

*A. Adoption of the draft UNCITRAL Legislative Guide on Secured Transactions (continued)
(A/CN.9/XL/CRP.1/Add.2)*

1. Chapter VII: Priority of a security right as against the rights of competing claimants (continued)

(b) Commentary (continued) (A/CN.9/631/Add.4)

15. **Mr. Smith** (United States of America) said that he opposed the amendment referred to in subparagraph 14 (xviii), namely inserting the word “present” before “right of set-off” in paragraph 112 of the commentary to chapter VII (A/CN.9/631/Add.4) and the words “unless it has disappplied such right” after “non-secured transactions law”. The Committee had not, in his recollection, reached a consensus on those amendments.

16. **Ms. Sabo** (Canada) said that the amendments appeared to reflect what the Committee had decided and that she would therefore prefer to maintain them.

17. **Mr. Weise** (Observer for the American Bar Association) said that, according to his notes, there had been some disagreement among delegations regarding the relevant rule and no consensus had been reached.

18. **Ms. Sabo** (Canada) said she was prepared in that case to accept the deletion proposed by the representative of the United States.

19. **The Chairman** said he took it that the Commission wished to delete the portion of paragraph 14 (xviii) relating to the fifth line of paragraph 112.

20. *It was so decided.*

21. *The section of the draft report on chapter VII and the commentary thereto, as amended, was adopted.*

2. Chapter VIII: Rights and obligations of the parties

(a) Recommendations (A/CN.9/631, recommendations 108-113) and (b) Commentary (A/CN.9/631/Add.5)

22. *The section of the draft report on chapter VIII and the commentary thereto was adopted.*

3. Chapter IX: Rights and obligations of third-party obligors

(a) Recommendations (A/CN.9/631, recommendations 114-127) and (b) Commentary (A/CN.9/631/Add.6)

23. *The section of the draft report on chapter IX and the commentary thereto was adopted.*

4. Chapter X: Post-default rights

(a) Recommendations (A/CN.9/631, recommendations 128-172) and (b) Commentary (A/CN.9/631/Add.7)

24. **Mr. Bazinas** (Secretariat) suggested moving the words “for example” in the fifth sentence of paragraph 5 to immediately before the words “a secured creditor”. He further suggested inserting the following sentence at the end of paragraph 5: “It was agreed that the commentary should explain the term ‘commercially reasonable standards’, giving examples.”

25. **The Chairman** said he took it that the Commission wished to adopt the Secretariat’s suggestions.

26. *It was so decided.*

27. **Mr. Bazinas** (Secretariat) suggested amending the first sentence of paragraph 8 to read: “With respect to the reference in recommendations 147, subparagraph (a), 149 and 150 to receiving or sending a notice, different views were expressed.”

28. *It was so decided.*

29. **Mr. Bazinas** (Secretariat) suggested inserting the phrase “as it referred to distribution of proceeds realized by a judicial disposition” at the end of the first sentence of paragraph 11. Furthermore, the reference to “recommendations 114-127” in paragraph 13 should be corrected to read “recommendations 128-172”.

30. **The Chairman** said that he took it that the Commission wished to adopt the Secretariat’s suggestions.

31. *It was so decided.*

32. *The section of the draft report on chapter X and the commentary thereto, as amended, was adopted.*

5. Chapter XII: Acquisition financing rights

(a) Recommendations (A/CN.9/631, recommendations 184-201)

33. *The section of the draft report on chapter XII contained in document A/CN.9/XL/CRP.1/Add.2 was adopted.*

34. *Document A/CN.9/XL/CRP.1/Add.2 as a whole, as amended, was adopted.*

A. Adoption of the draft UNCITRAL Legislative Guide on Secured Transactions (continued)
(A/CN.9/XL/CRP.1/Add.3)

5. Chapter XII: Acquisition financing rights (continued)

(a) Recommendations (A/CN.9/631, recommendations 184-201) (continued)

(ii) Non-unitary approach (continued)

(b) Commentary (A/CN.9/631/Add.9)

35. **Mr. Rehbein** (Germany) proposed replacing the words “proceeds other than inventory” in the fifth line of paragraph 8 with the words “proceeds of inventory”.

36. **Mr. Bazinas** (Secretariat) suggested amending the sentence to read: “Accordingly, the priority provided in the new recommendation should extend to proceeds of tangible property other than inventory, for example equipment, as well as to proceeds of inventory except proceeds of inventory in the form of receivables or other payment rights.”

37. **Mr. Rehbein** (Germany) said that the suggested new wording was acceptable.

38. **Ms. Sabo** (Canada) proposed replacing the term “tangible property” in the Secretariat’s suggested wording by the term “tangible assets” in order to reflect the preference expressed by one delegation during the Committee’s discussion.

39. **The Chairman** said that he took it that the Commission wished to adopt the Secretariat’s suggested wording as amended by the representative of Canada.

40. *It was so decided.*

41. *The section of the draft report on chapter XII contained in document A/CN.9/XL/CRP.1/Add.3 and the commentary thereto, as amended, was adopted.*

6. Chapter XIII: Private international law

(a) *Recommendations (A/CN.9/631, recommendations 202-222)*

42. **Mr. Salam-Alada** (Nigeria), referring to paragraph 12, noted that the Committee had agreed not only that the title to chapter XIII should be changed to “Conflicts of laws” or “Applicable law” but also that United Nations terminologists should be allowed to suggest any other suitable title. He therefore proposed that the phrase “or any other title suggested by United Nations terminological experts” should be inserted at the end of the paragraph.

43. *It was so decided.*

44. **Mr. Smith** (United States of America) proposed replacing the words “that were not” in paragraph 20 with the words “that may not be” because the Committee had not yet determined that

recommendation 204 was not appropriate for security rights.

45. *It was so decided.*

46. *The section of the draft report on chapter XIII contained in document A/CN.9/XL/CRP.1/Add.3, as amended, was adopted.*

47. *Document A/CN.9/XL/CRP.1/Add.3 as a whole, as amended, was adopted.*

A. Adoption of the draft UNCITRAL Legislative Guide on Secured Transactions (continued) (A/CN.9/XL/CRP.1/Add.4)

6. Chapter XIII: Private international law (continued)

(a) *Recommendations (continued) (A/CN.9/631, recommendations 202-222)*

48. **Mr. Voulgaris** (Greece) proposed placing the title of chapter XIII, “Private international law”, in square brackets because it might be replaced by a more appropriate term.

49. **Ms. Sabo** (Canada) said that the draft report reflected the status of the text at the time of the discussion. It was therefore preferable to leave the title unchanged.

50. *It was so decided.*

(b) *Commentary (A/CN.9/631/Add.10)*

51. **Mr. Bazinas** (Secretariat) suggested amending the end of paragraph 12 (v) to read: “and that, in some States, such matters could arise only in the context of judicial enforcement”.

52. *It was so decided.*

53. *The section of the draft report on chapter XIII and the commentary thereto, as amended, was adopted.*

7. Priority of a security right in a negotiable document or goods covered by a negotiable document/law applicable to the priority of a security right in a negotiable document or goods covered by a negotiable document

54. **Mr. Smith** (United States of America), referring to the third sentence of paragraph 13, said that there was only one exception to which the

general priority recommendations would apply. He therefore proposed replacing “two exceptions” in that sentence by “one exception”. In addition, the words “first exception” in the fourth sentence and “other exception” in the sixth sentence should be replaced with the word “exception”.

55. *It was so decided.*

56. *Section A.7 of the draft report, as amended, was adopted.*

8. Chapter XIV: Transition

(a) *Recommendations (A/CN.9/631, recommendations 223-230) and (b) Commentary (A/CN.9/631/Add.11)*

57. *The section of the draft report on chapter XIV and the commentary thereto was adopted.*

9. Financial contracts

58. *Section A.9 of the draft report was adopted.*

59. *Document A/CN.9/XL/CRP.1/Add.4 as a whole, as amended, was adopted.*

A. Adoption of the draft UNCITRAL Legislative Guide on Secured Transactions (continued)
(A/CN.9/XL/CRP.1/Add.5)

10. Chapter XII: Acquisition financing rights/non-unitary approach (continued)

60. **Mr. Bazinas** (Secretariat) suggested linking the discussion in paragraph 1 to an earlier decision by the Committee regarding the revision of certain definitions and recommendations by deleting the words “The Committee had before it” at the beginning of the paragraph and inserting the following text: “Recalling its decision that the recommendations of the non-unitary approach should use terminology based on the notion of ownership (see document A/CN.9/XL/CRP.1/Add.3, paras. 8 and 10), the Committee considered a proposal ...”.

61. **Mr. Marca Paco** (Bolivia) expressed concern that some of the Secretariat’s suggested amendments appeared to affect the substance of the report. It was difficult for delegations to consider such amendments when the Committee was on the point of adopting the text.

62. **Mr. Sekolec** (Secretary of the Commission) said that the report had been drafted immediately after each day’s meetings and that the original draft might therefore not have reflected the discussions with absolute accuracy. The amendments that had been suggested were not intended to change the outcome of the deliberations but rather to reflect them more accurately.

63. **Ms. Sabo** (Canada), speaking in her capacity as Chairperson of the Committee of the Whole, apologized for the fact that the Committee had made the Secretariat’s work difficult by proceeding in a somewhat fragmented manner and occasionally changing its views. The suggested amendments were intended to ensure that the draft report reflected the whole discussion on each issue and she therefore endorsed them.

64. **Mr. Marca Paco** (Bolivia) said that caution should be exercised under such circumstances to avoid introducing changes of substance or new ideas.

65. **The Chairman** said he took it that the Commission wished to adopt the amendment suggested by the Secretariat.

66. *It was so decided.*

67. **Mr. Smith** (United States of America) proposed replacing the words “the goods” in the phrase in brackets in the third sentence of paragraph 1 with “equipment”, and inserting the words “in equipment” after “priority” in the phrase in brackets at the end of the paragraph. The clauses within brackets were intended to remind the reader of the means whereby an acquisition financier achieved super-priority. However, they would be incomplete if they referred to all goods because additional conditions were required for a super-priority in inventory. The clauses would be accurate only if they were confined to super-priority of a security right in equipment.

68. **Mr. Kemper** (Germany) said that he was reluctant to accept the United States proposal because the Committee had decided that there would be two options for recommendations 189 and 192. One of those options would provide for equal treatment of equipment and inventory in terms of registration requirements. It might therefore be preferable to leave the wording more open than had

been suggested by the representative of the United States.

69. **Mr. Smith** (United States of America) said that it was on account of the existence of the two options that he had proposed confining the reference in the clauses in brackets to equipment. The result for equipment was, in fact, the same for the two options.

70. **Mr. Al-Anbaki** (Observer for Iraq) expressed a preference for the word “goods”, since it was more general and flexible and was in keeping with the technical and legal terms used by most countries.

71. **Mr. Salam-Alada** (Nigeria) proposed retaining the word “goods” and inserting the words “other than inventory” immediately afterwards.

72. **Mr. Smith** (United States of America) expressed support for that proposal.

73. **The Chairman** said he took it that the Commission wished to adopt the wording proposed by the representative of the United States as amended by the representative of Nigeria.

74. *It was so decided.*

75. **Mr. Kemper** (Germany), referring to paragraph 34, said that very few delegations had participated in the debate reflected in paragraph 33 and that proposed new recommendations 194 to 197 had not been adopted. It had been agreed that they should be redrafted, but his delegation had not yet seen the new version. He proposed that they should be considered at the Commission’s resumed session in December 2007 and that paragraph 34 should be reworded along the following lines: “While there seemed to be a tendency to reach agreement on the basis of this discussion, one delegation said that it first wished to see a draft of the text on rights in proceeds that would replace recommendations 194 to 197.”

76. **Mr. Bazinas** (Secretariat) suggested the following wording to reflect the point raised by the representative of Germany: “The Committee approved the substance of the proposed approach to recommendations 194 to 197 and agreed to review those recommendations at its resumed session.” That sentence would be followed by a reference in brackets to paragraph 25 of document A/CN.9/XL/CRP.1/Add.6, which reflected the

decision of the Committee to review those recommendations at its resumed session.

77. **Ms. Sabo** (Canada) said she agreed that paragraph 34 did not accurately reflect the Committee’s decision. The wording suggested by the Secretariat was preferable.

78. **Mr. Kemper** (Germany) said that he was unable to agree to the statement that the Committee had approved the substance of the proposed approach to the recommendations. Moreover, the text suggested by the Secretariat failed to mention a new draft version of the recommendations.

79. **Ms. Sabo** (Canada) proposed the following alternative wording: “The Committee expressed initial approval for the substance of recommendations 194 to 197 but agreed to review a draft of the recommendations in December 2007.” It would then be clear that the Committee would be considering both the drafting and the policy at the resumed session.

80. **Mr. Kemper** (Germany) said that he could accept the wording proposed by the representative of Canada, although he still took issue with the statement that the Committee had approved the substance of the recommendations.

81. **Mr. Burman** (United States of America) expressed support for the wording proposed by the representative of Canada.

82. The Chairman said he took it that the Commission wished to adopt the wording proposed by the representative of Canada.

83. *It was so decided.*

The meeting was suspended at 11.35 a.m. and resumed at 11.55 a.m.

84. **Ms. Walsh** (Canada), referring to paragraph 19, proposed replacing the word “goods” in the second sentence with “tangible asset”, the words “paid portion of their purchase price” in the same sentence with “value in excess of the obligation owing to the seller or lessor”, and the words “tangible property after” in the quoted material in the fourth sentence with “tangible asset in excess of”.

85. **Mr. Smith** (United States of America) said that while he had no objection to the proposed amendment to the fourth sentence, he objected to the

proposed amendments to the second sentence, since that sentence was intended to draw attention to a flaw in the recommendation that was corrected by the revised version in the fourth sentence.

86. **The Chairman** said he took it that the Commission wished to replace the words “property after” in the fourth sentence of paragraph 19 with “asset in excess of”.

87. *It was so decided.*

88. **Ms. Walsh** (Canada), referring to paragraph 36, proposed inserting the words “ownership would pass to the buyer or lessee” after “revised to provide that” in the third sentence and inserting the word “and” before “the seller or lessor”. The phrase in question would then read: “... the suggestion was made that the proposed text should be revised to provide that ownership would pass to the buyer or lessee ‘as against third parties’ and the seller or lessor would have a security right ...”.

89. *It was so decided.*

90. *Document A/CN.9/XL/CRP.1/Add.5, as amended, was adopted.*

A. Adoption of the draft UNCITRAL Legislative Guide on Secured Transactions (continued)
(A/CN.9/XL/CRP.1/Add.6)

10. Chapter XII: Acquisition financing rights/non-unitary approach (continued)

91. **Mr. Smith** (United States of America) said that paragraph 5 should be brought into line with the amendment to paragraph 13 of document A/CN.9/XL/CRP.1/Add.4 adopted earlier in the meeting. He proposed replacing the words “two exceptions” in the second line of paragraph 5 with “an exception” and deleting the word “first” in the second sentence and the word “other” in the fifth sentence.

92. *It was so decided.*

93. *The section of the draft report on chapter XII as a whole, as amended, was adopted.*

11. Insolvency

(a) Definitions and recommendations (A/CN.9/631, chapter XI) and (b) Commentary
(A/CN.9/631/Add.8)

94. **Mr. Redmond** (Observer for the American Bar Association) said that the second part of the first sentence of paragraph 11 was confusing in that it referred to “enacting States”. He suggested replacing it with the following phrase: “and, if necessary, in order to clarify the commentary, include additional recommendations from the Insolvency Guide”.

95. **The Chairman** said he took it that the Commission wished to adopt the suggestion by the observer for the American Bar Association.

96. *It was so decided.*

97. *The section of the draft report on chapter XI and the commentary thereto, as amended, was adopted.*

12. Securities and financial contracts

(a) Securities and (b) Financial contracts

98. **Mr. Kemper** (Germany) proposed deleting the last two sentences of paragraph 18, since Working Group VI had not been mandated to prepare an annex to the draft Guide on certain types of securities.

99. **Mr. Burman** (United States of America) said that, according to his notes, the Committee had decided to refer the matter to the Commission for a decision.

100. **Ms. Sabo** (Canada), speaking in her capacity as Chairperson of the Committee of the Whole, said she recollected that the Committee had agreed on the need for further work in order to define the precise scope of securities. The Committee had also noted that the matter would have to be referred to the Commission and that priority was to be given to intellectual property in the Working Group’s timetable. She therefore proposed adding the words “for future work” at the end of paragraph 18.

101. **Mr. Cochard** (Association française des entreprises privées) expressed support for the proposal made by the Chairperson of the Committee of the Whole.

102. **Mr. Kemper** (Germany) said that he was prepared to accept the amendment proposed by the Chairperson of the Committee of the Whole.

103. **The Chairman** said he took it that the Commission wished to adopt the amendment proposed by the Chairperson of the Committee of the Whole.

104. *It was so decided.*

105. *Section A.12 of the draft report, as amended, was adopted.*

13. Coordination with the draft Unidroit Model Law on Leasing

106. *Section A.13 of the draft report was adopted.*

14. Future work on the draft Guide

107. **Mr. Bazinas** (Secretariat) suggested amending paragraph 25 to reflect the exact wording of paragraph 12 of document A/CN.9/XL/CRP.1, which referred to the approval by the Commission of the decisions of the Committee of the Whole.

108. *It was so decided.*

109. *Section A.14 of the draft report, as amended, was adopted.*

15. Future work on security rights in intellectual property

110. *Section A.15 of the draft report was adopted.*

111. *Document A/CN.9/XL/CRP.1/Add.6, as amended, was adopted.*

The discussion covered in the summary record ended at 12.20 p.m.

**Summary record of the 855th meeting, held at the Vienna International Centre
on Monday, 10 December 2007, at 10 a.m.**

[A/CN.9/SR.855]

Temporary Chairperson: Mr. Sekolec (Secretary of the Commission)

Chairperson: Ms. Sabo (Vice-Chairperson) (Canada)

The meeting was called to order at 10.15 a.m.

Opening of the session

1. **The Temporary Chairperson** opened the resumed fortieth session of the United Nations Commission on International Trade Law (UNCITRAL, hereinafter referred to as “the Commission”).

Appointment of an acting Chairperson

2. **The Temporary Chairperson** announced that the Chairperson, Mr. Mitrović (Serbia), was unable to attend the resumed session and had suggested that he be replaced by Ms. Sabo (Canada), Vice-Chairperson.

3. *It was so decided.*

4. *Ms. Sabo took the Chair.*

Adoption of a draft UNCITRAL Legislative Guide on Secured Transactions and possible future work (A/CN.9/617, 620, 631 and Add. 1-11, and 637 and Add.1-8; A/CN.9/XL/CRP.10 and 11 and Add.1) (*continued*)

5. **The Chairperson** noted that at the first part of its fortieth session the Commission had adopted recommendation 4, subparagraphs (b) and (c), on the scope of the draft UNCITRAL Legislative Guide on Secured Transactions (hereinafter referred to as “the Guide”) with respect to intellectual property, securities and financial contracts as well as recommendations 74 to 230 (A/CN.9/631, chapters I and VII to XIV) and had approved the substance of the commentary on intellectual property (A/CN.9/631/Add.1), the substance of the commentaries to chapters VII to XIV (A/CN.9/631/Add.4 to 11) and the terminology (A/CN.9/631). She further noted that the following material considered at the first part of the session

could be reviewed: the recommendations on the extension of a retention-of-title right or a financial lease right to proceeds (non-unitary approach) and the commentary on the alternatives to the recommendations on the third-party effectiveness of a retention-of-title right or a financial lease right to proceeds (unitary and non-unitary approaches).

6. **Mr. Bazinas** (Secretariat) said that the Commission now had before it a complete set of revised recommendations and revised commentaries prepared by the Secretariat in the light of the decisions taken at the first part of the session (A/CN.9/637 and Add. 1 to 8). It also had before it documents containing commentaries that had not yet been approved (A/CN.9/631/Add.1 to 3). Two documents containing proposed revisions to the introduction, chapter I, section C of chapter II and chapter III (A/CN.9/XL/CRP.11 and Add.1), which had been prepared by the Secretariat to make the draft Guide more user-friendly, and a document submitted by the delegation of the United States containing proposals for amendments to some of the recommendations (A/CN.9/XL/CRP.10) were about to be distributed.

7. **The Chairperson** noted that the material relating to chapters IV to VI was already available. She therefore suggested that the Commission should begin by discussing chapter IV concerning the creation of a security right (effectiveness as between the parties).

8. *It was so decided.*

*Chapter IV: Creation of a security right
(effectiveness as between the parties)
(A/CN.9/631/Add.1 and 637)*

*Recommendations (recommendations 13 to 28)
(A/CN.9/637)*

Recommendation 13

9. *Recommendation 13 was adopted.*

Recommendation 14

10. **The Chairperson** drew attention to a note following the recommendation concerning the requirement in recommendation 14(b) to identify the secured creditor and the grantor in a security agreement. The Commission was asked to decide whether it would be sufficient, on grounds of confidentiality, for the security agreement to identify a representative of the secured creditor rather than the secured creditor itself.

11. **Mr. Umarji** (India) pointed out that a security agreement, unlike a notice of registration, was not accessible to the public. It would serve as the basis for action, however, in the event of enforcement either through the courts or on the part of the secured creditor. It followed that all particulars of the secured creditor must be disclosed.

12. *Recommendation 14 was adopted.*

Recommendation 15

13. **Mr. Sigman** (United States of America), supported by **Mr. Macdonald** (Canada), proposed inserting the words “by itself or” between the phrase “the agreement must be concluded in or evidenced by a writing that” and “in conjunction with the course of conduct between the parties” because the recommendation, as currently drafted, suggested that an investigation into the course of conduct was required in all cases, whereas the writing might be sufficient in itself.

14. *Recommendation 15, as amended, was adopted.*

Recommendations 16 to 28

15. *Recommendations 16 to 28 were adopted.*

Commentary to chapter IV: Creation of a security right (effectiveness as between the parties)
(A/CN.9/631/Add.I, paras. 142-247)

16. **The Chairperson** drew attention to a note by the Secretariat following paragraph 168 requesting the Commission to consider whether recommendation 14 should be revised in order to

clarify that, in cases where the secured creditor relinquished possession of an encumbered asset in which a security had been created by oral agreement and transfer of possession, a written agreement was necessary for the security right to continue to exist.

17. **Mr. Umarji** (India) said that in his view a written agreement was necessary in such circumstances.

18. **Mr. Macdonald** (Canada) proposed making that point clear in the commentary rather than amending recommendation 14.

19. *It was so decided.*

20. **Ms. Walsh** (Canada) proposed amending paragraphs 174 to 176 so that they presented the advantages and disadvantages of the following two options in a more balanced way: (a) requiring the security agreement to specify the maximum amount for which obligations could be secured; and (b) permitting unlimited future extensions of credit. The commentary seemed to favour the unlimited future advance option, although the recommendations were neutral on that point and left the policy decision to individual States. In the case of the first option, the purpose of specifying a maximum amount, which would be disclosed in a registered notice, was to alert third-party secured creditors to their potential priority position. The sentence in paragraph 175 to the effect that a maximum amount would protect the debtor from over-indebtedness and enable it to obtain additional credit from another party failed to provide States with sufficient guidance.

21. *It was so decided.*

22. **Ms. Walsh** (Canada) proposed amending the fourth sentence of paragraph 182, which stated that the lease agreement “must identify that asset as a lease” to read “must identify that asset as the grantor’s right as a lessee under the lease”.

23. *It was so decided.*

24. **Ms. Walsh** (Canada) noted that the second sentence of paragraph 184 concerning the right of parties to agree to create a security right in a future asset stated that the disposition was a present one but became effective as to the future asset only when the grantor became the owner of the asset or the asset came into existence. Two possibilities were

thus recognized but the distinction between them was unclear. In the first case, the grantor subsequently acquired an asset that already existed. In the second case, the asset only came into existence at a later point because it was manufactured. It was not logical to refer to the current disposition of a future asset, which implied that a property right was being transferred. She proposed amending the sentence to make it clear that the creation of the security right required either the acquisition or the coming into existence of the asset.

25. *It was so decided.*

26. **Ms. Walsh** (Canada) asked whether the Secretariat would be in a position to make editorial as opposed to substantive amendments in order to clarify the text after the Commission had concluded its deliberations.

27. **The Chairperson** said that the dividing line between editorial changes and substantive changes was sometimes difficult to establish. However, if she heard no objection from the members of the Commission, she would instruct the Secretariat to make such editorial changes as it deemed to be appropriate provided that there was no doubt as to their status. At the same time, she encouraged Commission members to suggest editorial changes that seemed, in their view, to be important and that could be dealt with speedily.

28. **Ms. Walsh** (Canada) noted that the last sentence of paragraph 190 recommended that general descriptions of present and future inventory be permitted, although paragraphs 188 and 189 dealt not just with inventory but with generic categories of future assets. She therefore proposed replacing “inventory” with “assets”.

29. *It was so decided.*

30. **Ms. Walsh** (Canada) pointed out that while paragraph 190 mentioned that some legal systems restricted security rights in future-acquired assets in the interests of consumer protection, section (d) concerning security in all assets of a grantor (paras. 191 to 199) failed to mention that limitation. She proposed either inserting such a reference or, alternatively, merging sections (c) and (d).

31. **The Chairperson** said she took it that the Commission agreed to leave it to the Secretariat to take Ms. Walsh’s comment into account.

32. *It was so decided.*

33. **Ms. McCreath** (United Kingdom) objected to the following phrase in the first sentence of paragraph 196: “all-asset security rights take the form of a so-called ‘floating charge’ that is merely a potential security right”. She proposed deleting the word “so-called” and indicating that a floating charge was indeed a security right rather than a potential security right.

34. *It was so decided.*

35. **Ms. Walsh** (Canada), referring to paragraph 222 concerning tangible property commingled in a mass or product, proposed placing greater emphasis on the fact that the automatic security right in a manufactured or processed product was limited to the value of the tangible asset prior to the commingling.

36. *It was so decided.*

37. **Ms. Walsh** (Canada) noted that section B.2 concerning the effectiveness of an assignment of receivables made despite an anti-assignment clause (paras. 229 to 232) set out the policy rationale for discouraging anti-assignment clauses in the case of certain categories of receivables but failed to explain why such clauses were acceptable in some cases and unacceptable in others. She proposed amending the commentary to make it clear why anti-assignment clauses were invalidated with respect to the assignment of certain types of receivables and upheld with respect to the assignment of other types.

38. *It was so decided.*

39. **Ms. Walsh** (Canada) proposed amending the second sentence of paragraph 247 concerning the creation of a security right in a negotiable document or goods covered by a negotiable document to read: “As a result, ... provided that the security right in the document is created while the goods are covered by the document of title.”

40. *It was so decided.*

41. *The substance of the commentary to chapter IV was approved subject to the agreed amendments.*

Chapter V: Effectiveness of a security right against third parties (A/CN.9/631/Add.2 and 637)

Recommendations (recommendations 29 to 53) (A/CN.9/637)

42. *Recommendations 29 to 53 were adopted.*

Commentary to chapter V: Effectiveness of a security right against third parties (A/CN.9/631/Add.2, paras. 1-130)

43. **Ms. Walsh** (Canada) drew attention to the second sentence of paragraph 17, which stated that specialized “control” rules were often enacted to apply to a security right in a right to payment of funds credited to a bank account and in a right to proceeds under an independent undertaking. As that approach, which the draft Guide was recommending, would be novel for most States, she proposed amending the opening phrase to read: “Some jurisdictions have enacted specialized ‘control’ rules.”

44. *It was so decided.*

45. **Ms. Walsh** (Canada) proposed amending the second last sentence of paragraph 20, which referred to an exception to the principle of non-exclusivity flowing from the particular character of letter of credit transactions, to make it clear that that approach was being recommended by the draft Guide.

46. *It was so decided.*

47. **Ms. Walsh** (Canada) drew attention to paragraph 42, which referred to the policy in some States of allowing a judgement creditor to obtain a security right in an encumbered asset through registration in the security rights registry and to the consequences of that policy in cases of insolvency. In her view, the comment to the effect that the judgement debtor’s insolvency representative was generally entitled to claim the monetary benefit of a registered judgement creditor’s priority for the benefit of all unsecured creditors did not accurately reflect the treatment of judicial hypothecs in most States. She therefore proposed deleting the first sentence and amending the second sentence to read: “In States that adopt this approach it is necessary to ensure that the judgement creditor’s rights are compatible with insolvency policies.” The final

sentence to the effect that the draft Guide made no recommendation on that point because it was an issue for insolvency law should be retained.

48. *It was so decided.*

49. **Ms. Walsh** (Canada) noted that some passages in section 8 (paras. 95 to 98) concerning continued third-party effectiveness of a security right after a change in the location of the asset or the grantor failed to make it clear that the recommended rule was applicable in all cases to both situations, namely a change in the location of the grantor, where that was the relevant connecting factor for the application of choice-of-law rules, or a change in the location of the asset, where that was the relevant connecting factor. She proposed that the commentary on section 8 should be clarified.

50. *It was so decided.*

51. **Ms. Walsh** (Canada) proposed replacing “Other States” at the beginning of paragraph 115 with “Some States”.

52. *It was so decided.*

53. **Ms. Walsh** (Canada) drew attention to the comparison in paragraph 117 between (a) the approach that gave priority among secured creditors with a security right in accounts to the security creditor that was the first to register, and (b) the approach that gave priority first to the depositary bank and then to any other secured creditor that had achieved control by replacing the grantor as the bank’s customer on the account. The first approach was described as ensuring transparency and permitting the grantor to create a security right without obtaining the consent of the depositary bank. The second approach was then stated to be “more in line with banking practice”, which was not strictly true since only a few States had opted for that approach. She therefore proposed that the commentary should explain in greater detail why States had opted for the first approach and why the draft Guide was recommending that they opt for the second approach. A more appropriate justification than banking practice was, in her view, the need to protect depositary banks from interference with their control over accounts and to protect their set-off rights in line with existing obligations.

54. *It was so decided.*

55. *The substance of the commentary to chapter V was approved subject to the agreed amendments.*

Chapter VI: The registry system (A/CN.9/631/Add.3 and 637)

Recommendations (recommendations 54 to 72) (A/CN.9/637)

Recommendations 54 to 56

56. *Recommendations 54 to 56 were adopted.*

Recommendation 57

57. *Recommendation 57 was adopted.*

Proposed additional recommendations X, Y and Z

58. **The Chairperson** drew attention to a note by the Secretariat following recommendation 57 concerning the required content of a notice, which proposed inserting three additional recommendations (X, Y and Z) that might be entitled “Erroneous notices”.

59. **Mr. Cohen** (United States of America), referring to recommendation X concerning an error in the identifier or address of the secured creditor or its representative, proposed amending the phrase “ineffective as long as it has not seriously misled a reasonable searcher” at the end of the recommendation to read “ineffective unless it would seriously mislead a reasonable searcher”. The new wording would set an objective standard and would not depend on evidence that a particular searcher had been misled. It was also consistent with the wording of recommendation 58.

60. **Mr. Riffard** (France), supported by **Mr. Cohen** (United States of America), suggested introducing the same rule into recommendation Y, which dealt with an error in the description of certain encumbered assets. As currently worded, recommendation Y stated that such an error would not render a registered notice ineffective “with respect to other assets”. He proposed adding a second sentence to the effect that the error would not render the notice ineffective with respect to the insufficiently described assets unless it would seriously mislead a reasonable searcher.

61. **Mr. Bazinas** (Secretariat) suggested making that point instead in recommendation X and leaving

recommendation Y unchanged because it addressed the separate issue of whether an error in the description of certain assets invalidated the notice with respect to other sufficiently described assets.

62. **Mr. Sigman** (United States of America) said that another alternative was to add a free-standing recommendation that would apply the “reasonable searcher” test not only to the description of encumbered assets but also to any other content of the notice except for the duration and maximum amount, which were dealt with in recommendation Z, and the provision of recommendation 58, which had already been approved by the Commission.

63. **Mr. Umarji** (India) said that the point made in recommendation Y was simply that in a notice containing two descriptions, one that was sufficient and the other insufficient, the validity of the former would not be affected. The question of misleading information did not arise in that context.

64. **Mr. Schöfisch** (Germany) queried the use of the term “error”, which could be construed as meaning an error on the part of the reader, whereas the recommendations were in fact referring to the provision of incorrect information.

65. **The Chairperson** said that the term “error” referred to incorrect statements made by the party registering the notice, a fact that should perhaps be made clear in the text.

66. **Mr. Weise** (Observer for the American Bar Association) said that the point raised by the representative of France was already addressed in recommendation 63, according to which a description of the encumbered assets was sufficient if it met the requirements of recommendation 14(d), namely that such assets should be described in a manner that reasonably allowed their identification. Recommendation Y could therefore refer to descriptions of encumbered assets that failed to meet the requirements of recommendation 63.

67. **Mr. Riffard** (France) said that the point he had raised was somewhat different. He had been referring, for example, to a registrant who described an encumbered asset such as a BMW vehicle as a Z4 model when it was actually a Z3 model. His proposed amendment was designed to ensure that such minor errors of description did not render a notice ineffective.

68. **Mr. Sigman** (United States of America) said that an incorrect statement such as that described by the representative of France should clearly be ignored if the remainder of the description was complete and accurate.

69. **Mr. Marca Paco** (Bolivia) said that a law which highlighted the possibility of registrants entering mistaken information in a notice was likely to cause concern and create confusion among creditors. He therefore proposed that the recommendations concerning erroneous notices should be deleted.

70. **The Chairperson** said that the policy considerations underlying the proposed new recommendations were how to balance the need for certainty with the need to ensure that a debtor could not seize on a minimal error in a notice to invalidate the registration. The idea was to set a standard in the light of which an incorrect statement could be assessed.

71. **Mr. Bazinas** (Secretariat) said that the proposed new recommendations were designed to preserve the validity of a notice containing a minor incorrect statement regarding items that were not indexing or search criteria and to prevent uncertainty as to whether a legitimate creditor had obtained a security right that was effective against third parties and that enjoyed priority based on registration of the notice.

72. **Mr. Riffard** (France) expressed support for the proposed new recommendations, since they sent an important message to legislators, namely that care should be taken to maintain balance between the interests of creditors and grantors. Debtors or grantors operating in bad faith or judges who were inclined to protect grantors against what they assumed to be bullying creditors should not be permitted to seize on a minor error in order to invalidate a security right and its registration on unreasonable grounds.

73. Recommendation Z stated that an error in the information provided in the notice with respect to the duration of registration and the maximum amount secured did not render a registered notice ineffective. It might therefore be concluded that an error had absolutely no consequences, in which case a reasonable registrant would refrain from entering any maximum amount. He proposed describing in the commentary to recommendation Z the practical consequences of the provision of erroneous information regarding the duration of registration and the maximum amount secured.

The meeting rose at 12.30 p.m.

**Summary record of the 856th meeting, held at the Vienna International Centre
on Monday, 10 December 2007, at 2 p.m.**

[A/CN.9/SR.856]

Chairperson: Ms. Sabo (Canada)

The meeting was called to order at 2.10 p.m.

**Adoption of a draft UNCITRAL Legislative Guide
on Secured Transactions and possible future work**

(A/CN.9/617, 620, 631 and Add. 1-11, and 637 and
Add.1-8; A/CN.9/XL/CRP.10 and 11 and Add.1)

(continued)

*Chapter VI: The registry system (A/CN.9/631/Add.3
and 637) (continued)*

*Recommendations (recommendations 54 to 72)
(A/CN.9/637) (continued)*

*Proposed additional recommendations X, Y and Z
(continued)*

1. **The Chairperson** said she took it that the Commission agreed to include proposed additional recommendations X, Y and Z in chapter VI.

2. *It was so decided.*

3. **Ms. Walsh** (Canada) proposed replacing the phrase “does not render a registered notice ineffective” in recommendations X, Y and Z with the phrase “does not render the registration of a notice ineffective”. The recommendations on third-party effectiveness in the draft Guide described the registration of a notice as a mode of third-party effectiveness. The question to be addressed was thus whether an error in the notice would invalidate registration as a mode of third-party effectiveness.

4. The representative of France had made the point that a debtor or grantor might seek to render a registration ineffective. She pointed out that such a tactic would have no impact on the effectiveness of the registration of a security right as between the parties but might impinge on its effectiveness against third parties. With that proviso, she agreed with his point that it might be in the interest of third parties to argue that a minor error rendered the registration ineffective.

5. With regard to recommendation Z, the representative of France had pointed out that an error in the description of the duration of registration or the maximum amount secured seemed to have no consequences whatsoever. In practice, if a security agreement specified \$100,000 as the maximum amount for which security was created and the registered notice set the amount at \$50,000, third parties would be entitled to rely on the lower amount. A subordinate creditor would conclude from the notice that it would have priority for any loans made above \$50,000. On the other hand, registration would not be ineffective for the first secured creditor, which would be bound by the amount of \$100,000. However, in the converse situation where the registered notice stated \$100,000 and the security agreement only \$50,000, the secured creditor would be limited to the latter amount. Similarly, if a shorter period was specified in the registered notice than in the security agreement, the registered duration would be conclusive from the point of view of third parties.

6. Lastly, she noted that recommendation Y, as currently worded, might not cover all conceivable situations. She therefore proposed first stating that an error in the description of encumbered assets did not render a notice ineffective unless it would be seriously misleading and then making the point that if an error as seriously misleading the registration was ineffective only with respect to assets that were inaccurately described and not with respect to other assets that were accurately described.

7. In response to a question from **Mr. Bazinas** (Secretariat) regarding her comment that third parties should be entitled to rely on the duration or the maximum amount stated in the notice of registration, **Ms. Walsh** (Canada) said that her point related only to recommendation Z and not to recommendations X and Y.

8. **Mr. Cohen** (United States of America), supported by **Mr. Schöfisch** (Germany), proposed moving recommendations X, Y and Z to after recommendation 58.

9. **The Chairperson** suggested leaving it to the Secretariat to decide on the most logical order of the recommendations.

10. **Mr. Schöfisch** (Germany) noted that recommendation 58 referred to an “incorrect statement”. He suggested establishing as the main rule that an incorrect statement was ineffective only when it would seriously mislead a reasonable searcher. In his view, it was not really necessary to differentiate between different aspects of the same rule. The draft Guide was not supposed to deal with every conceivable topic but to provide general recommendations to States and legislators.

11. **Mr. Smith** (United States of America), referring to the proposal by the representative of Canada to replace the phrase “does not render a registered notice ineffective” with “does not render the registration of a notice ineffective”, said that he found the original wording more accurate since registration occurred in due form but the notice contained erroneous information.

12. He proposed clarifying in recommendation Z that third parties should be entitled to rely on the duration or the maximum amount stated in the notice of registration.

13. **Mr. Patch** (Australia), referring also to recommendation Z, said that a person that entered a shorter duration in the notice of registration than that contained in the security agreement must obviously be bound by the shorter duration. Another issue arose, however, where the period stated in the notice of registration was longer than that permitted by the relevant legislation. He proposed stating in recommendation Z that the default period under such circumstances was the maximum period permitted by law. Similarly, where the legislation prohibited a secured party from specifying a maximum amount that exceeded a certain proportion of the debtor’s assets and the amount stated in the notice of registration exceeded that proportion, the default amount should, in his view, be the maximum permitted by the relevant legislation.

14. **Ms. Walsh** (Canada) said that the recommendations did not purport to deal with errors of law but with errors involving a difference between the way in which the terms agreed on by the grantor and the secured creditor were reflected in the security agreement and the notice of registration in jurisdictions that adopted the system recommended by the draft Guide. The issue raised by the representative of Australia would arise only in connection with the duration of the registration, where there were two possibilities: the parties could either self-select or States could specify a maximum amount in their legislation. She did not think that the recommendations should cover errors occurring in that context. A registered duration which exceeded that permitted by law would clearly be ineffective, but the registry would normally be designed to prevent such errors from occurring.

15. She did not consider it necessary to state in recommendation Z that third parties were entitled to rely on the maximum amount registered.

16. With regard to the proposal to establish as the main rule that an incorrect statement was not fatal to the status of the registration unless it was seriously misleading, she felt that it would be more helpful to spell out all the possibilities, which were, broadly speaking, an error in description, an error in duration (in systems that opted for self-selection) and an error in the name.

17. Although she was not convinced by the argument put forward by the representative of the United States, she would not insist on her proposal to replace “does not render a registered notice ineffective” with “does not render the registration of a notice ineffective”. She had merely sought to align the wording with that used in the chapter on third-party effectiveness.

18. **Mr. Sigman** (United States of America) said that it should be made clear when spelling out the consequences of errors that a person who had relied to its detriment on false information was protected from those consequences.

19. He agreed that errors with respect to duration were different from other kinds of errors. Where a jurisdiction imposed a specific duration, errors would be corrected by the registry system. If there were no such restraints on the registrant,

discrepancies would also be corrected, since if the registrant paid for 5 years and stated 10 years on the notice, the notice would be cancelled after the expiry of the five-year term, while if the registrant paid for 10 years and stated 5 years on the notice, the registrant could amend the notice at any time. In cases where the grantor might be harmed, the draft Guide already contained provisions requiring the secured creditor to terminate the notice and entitling the grantor to institute legal proceedings or to have the notice amended in the registry.

20. **Mr. Riffard** (France) noted that in the case of recommendations X and Y, the consequence of an error was that the notice was still effective and, where the error was minor, it was effective vis-à-vis third parties that had consulted the registry and could employ reasonable means to remedy the situation. The notice was thus effective vis-à-vis the actual situation and not vis-à-vis the erroneous statement in the notice. He submitted that the consequence of an error should be similar in the case of recommendation Z. For example, where a notice stated a maximum amount or duration that exceeded the amount or duration in the security agreement, the erroneous figure should be ineffective vis-à-vis third parties that had no access to the security agreement and were therefore unable to take action to correct the error.

21. **Ms. Walsh** (Canada) **Mr. Umarji** (India) concurred with that view.

22. **The Chairperson** invited the Secretariat to summarize the discussion on the proposed new recommendations.

23. **Mr. Bazinas** (Secretariat) noted that the Commission seemed to agree that the word “error” should be replaced by “incorrect statement”.

24. If a reference to the description of encumbered assets were included in recommendation X, the following wording might be acceptable: “The law should provide that an incorrect statement in the identifier or address of the secured creditor or its representative or in the description of the encumbered assets does not render a notice or registration ineffective unless it would seriously mislead a reasonable searcher.”

25. **The Chairperson** said that, if she heard no objection, she would take it that the Commission

approved the amended wording of recommendation X. The commentary should make it clear that the term “incorrect statement” referred to a statement made by the registering party.

26. *Recommendation X, as amended, was adopted.*

27. **Mr. Bazinas** (Secretariat) noted that the Commission seemed to agree that recommendation Y could remain unchanged apart from the replacement of the word “error” by “incorrect statement”.

28. **The Chairperson** said she took it that the Commission approved the amended wording of recommendation Y.

29. *Recommendation Y, as amended, was adopted.*

30. **Mr. Bazinas** (Secretariat) said that there seemed to be broad agreement in the case of recommendation Z on the principle that a third party that suffered damage on account of having relied on incorrect statements in notices of registration should be protected. However, he sensed that there was some difference of opinion regarding the status of third parties in the event of discrepancies between the maximum amount stated in the security agreement and the notice of registration.

31. **Mr. Patch** (Australia) enquired about the practical consequences of the receipt by the registry of a notice specifying a duration of registration that exceeded the maximum period permitted by law.

32. **Mr. Bazinas** said that the registry’s response would depend on its structure. However, in a jurisdiction that prescribed a maximum duration of registration, the result would be the same regardless of the registry’s response. It followed that there was no need to amend recommendation Z.

33. **Mr. Patch** (Australia) said he understood that if the electronic message sent by the registrant specified a period greater than the maximum duration permitted by the legislation, the registration would be effective only for the maximum period allowed by the legislation.

34. **Ms. Walsh** (Canada) suggested that the question of an error in law by the registrant should be addressed in the commentary.

35. She confirmed that third parties should be protected where the security agreement specified a

maximum amount that was greater than the amount appearing in the registered notice. In that eventuality, the registrant could enforce its security right against the grantor up to the outstanding amount of the secured obligation, but would have priority over competing claimants only up to the lower amount mentioned in the notice. Conversely, where the amount specified in the security agreement was less than the amount that appeared in the registered notice, the registrant could enforce its security right with priority only up to the amount mentioned in the security agreement. Recommendation Z did not need to address those situations since they were covered elsewhere in the draft Guide.

36. **Mr. Sigman** (United States of America) said that he was opposed in principle to the inclusion of a maximum amount in the registered notice. However, in jurisdictions that adopted that approach it was important to protect a person that reasonably relied on erroneous information from suffering the consequences. In most transactions, a prospective lender would obtain a copy of the security agreement from the grantor or the prior registered secured creditor. If the amount appearing in the notice was less than that in the security agreement, it would not be misled by the error in the notice.

37. **Ms. McCreath** (United Kingdom) asked who would be held responsible where a party was misled by an error.

38. **Mr. Sigman** (United States of America) said that the question of responsibility would not normally arise. It was rather an issue of consequences, and the consequences would vary in terms of the extent to which the secured right was enforceable with priority vis-à-vis the protected party.

39. **Ms. Kaller** (Austria) said that the term “reasonable searcher” seemed to imply that a third party was required to search for information beyond the registry in order to determine, for example, whether an error had been made in the notice.

40. **Mr. Bazinas** (Secretariat) said that the function of the registry was not to provide all available information about the existence of a security right but to serve as a warning signal to a reasonable searcher that a certain asset might be

subject to another security right. To ascertain whether that was the case, information outside the registry would have to be sought. The commentary made it clear that a reasonable searcher had to search the registry on the basis of the name of the grantor in order to identify a notice. If it wished to check whether the assets of a party to which it proposed to extend credit were already encumbered, it would have to search outside the registry.

41. **Ms. Walsh** (Canada) said that the concern expressed by the representative of Austria was valid, since the term “reasonable searcher” might be construed as suggesting that an additional enquiry obligation arose in the event of an error in the notice. The commentary should make it clear that the question of whether a reasonable searcher was misled related solely to the information provided in the registry.

42. **The Chairperson** noted that there was broad agreement that recommendation Z should make it clear that, in systems requiring the specification of a maximum amount, protection should be provided for third parties that might have relied on that amount to their detriment. In systems where the law prescribed a maximum duration of registration, the registry would normally be structured in such a way as to prevent periods greater than the maximum duration from being registered. In any case, users of the system would presumably be aware of the rules. Where a system left the registering party free to select any period of time, third parties should, of course, be able to rely on the duration specified in the notice.

43. If she heard no objection, she would take it that the Commission wished to adopt recommendation Z, replacing the word “error” by “incorrect statement” and adding a clause dealing with the consequences that would flow from a third party relying on an incorrect statement. The question of an error in law by the registrant would be addressed in the commentary.

44. *Recommendation Z was adopted on that understanding.*

45. **Mr. Macdonald** (Canada) said that he had noticed a possible discrepancy between an earlier chapter of the draft Guide and the chapter on the registry system under discussion. According to

recommendation 57 (d), in cases where a State determined that a maximum monetary amount would help to facilitate subordinate lending, the notice should contain a statement of that maximum amount. However, recommendation 14 in chapter IV concerning the form of a security agreement failed to refer to that eventuality. In his view, it was important to include a statement of maximum amount in the security agreement because otherwise a secured creditor might unilaterally set a maximum amount in the registered notice without reference to any prior agreement with the grantor.

The meeting was suspended at 3.30 p.m. and resumed at 3.55 p.m.

46. **The Chairperson** said she took it that the Commission wished to include wording along the lines of recommendation 57 (d) in recommendation 14.

47. *It was so decided.*

48. **Ms. Walsh** (Canada) proposed emphasizing in the commentary that the minimum content requirements could be satisfied in the case of recommendation 14 by means of a number of different agreements on condition that they were cross-referenced. It was not necessary to set out all relevant information in a single security agreement.

49. *It was so decided.*

50. **Ms. McCreath** (United Kingdom) queried the inclusion of the word “only” in the chapeau of recommendation 57: “The law should provide that the following information only is required to be provided in the notice.” In her view, that wording was unduly restrictive. For instance, certain information that was not listed in recommendation 57 had to be included in a notice of registration in the United Kingdom.

51. **The Chairperson** said that the wording of recommendation 57 had been discussed at length by Working Group VI (Security Interests) and had already been approved in principle by the Commission.

52. **Ms. Walsh** (Canada) said that the purpose of the restriction on the amount of information provided in the registered notice was to prevent confusion by standardizing the information that third parties would need to see in order to protect

their interests. Any additional information would place an additional burden on the registry and make it more difficult for third parties to identify aspects that were relevant to their legal rights.

53. **Mr. Sigman** (United States of America) said that limiting the content of the notice would promote the acceptability of a registry in countries that were unaware of the existence of such a device. If the information to be registered was short and simple, States could design an inexpensive electronic registration system that could be used by both laypersons and financial institutions.

Recommendations 58 to 60

54. *Recommendations 58 to 60 were adopted.*

Recommendations 61 and 62

55. **Mr. Umarji** (India) said that recommendation 62 concerning the impact of a transfer of an encumbered asset on the effectiveness of the registration placed the onus of amending the registration within a specified time on the secured creditor rather than on the grantor or the transferee. That approach was not workable in practice and was incompatible with the object of the draft Guide, which was to encourage secured credit. The rights of a secured creditor should be protected in cases where, for instance, a grantor concealed the transfer of an encumbered asset. He therefore proposed amending the recommendation to place the onus of amending the registration on the grantor or the transferee.

56. **Mr. Smith** (United States of America) said that the representative of India had raised an important policy issue. Where an asset was transferred subject to a security right, the transferee might wish to obtain credit from another secured creditor or to sell the encumbered asset. The secured creditor of the transferee would in any case have a duty of due diligence to clarify the chain of title of the asset. Hence, it would be a sensible policy judgement to place the burden of determining whether the security right had been released on the secured creditor of the transferee or on the buyer from the transferee rather than on the original secured creditor.

57. **Ms. Walsh** (Canada) said that placing the burden on the transferee seemed illogical in light of the policy objective of the recommendation, which was to protect a transferee or subsequent secured creditor in dealings with a grantor that had dealt with a prior secured creditor under a different identifier.

58. **Mr. Patch** (Australia) said that the obligation to update the registered notice should be on the original secured creditor but recommendation 62 should be amended to extend the period during which the secured party, which might initially be unaware of the transfer of the asset, could update the registration. The transferee or the transferee's secured creditor had no incentive to effect a registration that would protect the interest of the transferor's secured creditor.

59. **Mr. Bazinas** (Secretariat) suggested that the proposal by the representative of India might be reflected in recommendation 62 by stating that the grantor or the transferee should inform the secured creditor of the transfer of an encumbered asset. The onus would then be on the secured creditor to take the necessary action.

60. **Mr. Umarji** (India) said that the Secretariat's suggestion was acceptable. Due notice of the transfer should be given to the original security creditor, which, if it consented to the transfer, would amend the registered notice. The original security right would continue after the transfer.

61. **Ms. McCreath** (United Kingdom) said that if the amendment suggested by the Secretariat was accepted, the words "after the transfer" in the second sentence of the recommendation should be amended to read "after notice of the transfer is given".

62. **Mr. Smith** (United States of America) the situation under discussion arose when a grantor transferred an encumbered asset subject to a security right. In many cases, however, the secured creditor would be unaware of the transfer. If the transferee had consulted the public filing system, it would have found a notice against the grantor covering the encumbered asset. The transferee might, however, fail to do so and seek to borrow money from another lender on the basis of the encumbered asset. The question was whether the second lender had an

obligation of due diligence to establish whether the asset came free of a security right or whether it could simply rely on the registration system. A rule requiring the transferee to correct the record would serve no purpose if the transferee neglected to search the registry and was unaware of the security right. Moreover, a rule requiring the secured creditor of the transferor to correct the public record when it was notified of the transfer would not affect the obligation of due diligence of the secured creditor of the transferee because the latter could not be sure that there was no secured creditor of the transferor that was unaware of the transfer. It followed that the best option was to place the risk on the secured creditor of the transferee rather than imposing monitoring costs on the secured creditor of the transferor, which would drive up the cost of credit.

63. **Mr. Patch** (Australia) said that he agreed to some extent with the approach just described. The grantor and the transferee had little incentive to register because they were probably acting contrary to the security agreement. The question was whether to impose monitoring costs on the transferee and the transferee's creditor or, alternatively, on the transferor's creditor. He suggested that the grantor's secured creditor should be required to register within a period of, say, five days of becoming aware of the transfer of the asset. After that period expired without registration, a secured creditor of the transferee could be confident of taking a security right in the asset. If the grantor's secured creditor was unaware of the transfer, it would continue to have priority over the security rights of the transferee's secured creditor, but if the transferee's secured creditor became aware of the security right through due diligence, it could put the grantor's secured creditor on notice, wait for the grace period to expire and take a security right in the asset if the grantor's secured creditor failed to register. The transferee's secured creditor thus had an incentive to give notice to the grantor's creditor.

64. **Ms. Walsh** (Canada) said that she did not think it would be helpful for the draft Guide to impose an obligation on the grantor to inform its secured creditor of a transfer of the collateral, since the problem being addressed was a situation in which the grantor transferred collateral without the authorization or consent of its secured creditor. That

would normally constitute a breach of the security agreement.

65. The draft Guide assumed that anybody purchasing or taking security in an asset would undertake a search of the registry. It followed that the transferee ought to have checked the registry and realized that it was acquiring the asset subject to a prior security right. Where the transferee then approached a new secured creditor or buyer, a search of the registry by the lender or buyer would fail to reveal the security right because it was indexed in the name of the grantor and not in the name of the transferee. There were therefore two innocent victims: the first secured creditor whose asset was transferred without consent or authorization, and the buyer or secured creditor that was dealing with the transferee in the belief that it was the unencumbered owner of the asset. The question was whether the resulting loss should be borne by the secured creditor or buyer that dealt with the transferee or by the original secured creditor. The Working Group had decided that it was important to protect the reliability of the registry system, which was grantor-based. If the transferee's secured creditor or the buyer found no security right in the registry, it was not encumbered by the existing right.

66. Her delegation was not averse to adopting a rule which stated that the original secured creditor would not be at risk for failing to amend the registry following a transfer unless it failed to amend it within a short period after finding out about the transfer. As a compromise, she proposed applying that rule where the encumbered asset was transferred to another secured creditor that would presumably have the expertise and resources to investigate whether there was a prior security right. On the other hand, where a buyer acquired the asset from the transferee before the amendment was made, the buyer should be protected in all cases.

67. **Mr. Schneider** (Germany) said that he agreed with the representative of India that recommendation 62 was unsatisfactory, since it placed the burden of amending the registration on the secured creditor although it might well be unaware of the transfer of the encumbered asset. There was no incentive for the grantor to inform the secured creditor. Moreover, if the grantor was not the debtor, no contractual relationship and hence no

statutory duty existed. He wondered why it was necessary to amend the registration of a security right and why the secured creditor would lose its rights if there was no amendment.

68. **Mr. Sigman** (United States of America) said he took it that the representative of Germany was suggesting that recommendation 62 should be deleted. In his view, that was the simplest solution. The proposed amendment to recommendation 62 to protect two presumably innocent secured parties would merely increase the complexity of the draft Guide. If the recommendation was deleted, the original secured party would be relieved of the monitoring burden imposed by a provision requiring it to amend the record at some point. Requiring knowledge on the part of the secured creditor could lead to litigation regarding issues such as whether the secured creditor had knowledge, what constituted knowledge and when knowledge was required. The least costly overall burden on the system was to dispense with the duty to amend the record. The idea of having separate rules for buyers and secured parties was particularly undesirable in terms of the objective of keeping the draft Guide as simple as possible.

69. **Mr. Umarji** (India) said that the draft Guide should not be perceived as condoning the behaviour of a grantor that transferred an encumbered asset without disclosing the transfer to the secured creditor.

70. **Mr. Voulgaris** (Greece) expressed support for the point made by the representative of India. It should be borne in mind that the secured creditor held a security right in rem. If it was made responsible for the subsequent transfer of the encumbered asset, responsibilities were in effect being reversed. The secured creditor could not be expected to play the role of a detective vis-à-vis the grantor. Recommendation 62 should therefore either be deleted or amended in such a way as to require the grantor to inform the secured creditor of any transfer of an encumbered asset. Failure to do so should under no circumstances entail the loss of the secured creditor's security right.

71. **Mr. Boulet** (Observer for Belgium) said that, as noted by the representative of Canada, there were two potential innocent victims, the buyer and the original secured creditor. The rule stated in

recommendation 62 was therefore unsound, since it would be inappropriate to punish the original secured creditor for a transfer of the encumbered asset for which it was not responsible. The grantor could perhaps be required to inform the original secured creditor of the transfer, following which it would be more reasonable to require the latter to amend the notice. The situation was somewhat different in the case of a buyer inasmuch as it could be expected to check the registry in order to determine whether the asset transferred by the grantor was encumbered by a prior security right.

72. **Mr. Deschamps** (Canada) said that his delegation was in favour of retaining a revised version of recommendation 62. He proposed amending the second sentence of the recommendation to read: “If the secured creditor does not register the amendment within [a short period of time to be specified] days after acquiring knowledge of the transfer, the security right is ineffective against ...”.

73. **Mr. Markus** (Switzerland) expressed support for the proposal to delete recommendation 62 for the reasons stated by the representative of the United States. The concept of acquired knowledge was difficult to prove and the occasions in which an original secured creditor would wish to amend a registered notice were, in his view, extremely rare.

The meeting rose at 5 p.m.

**Summary record of the 857th meeting, held at the Vienna International Centre
on Tuesday, 11 December 2007, at 9.30 a.m.**

[A/CN.9/SR.857]

Chairperson: Ms. Sabo (Canada)

The meeting was called to order at 9.40 a.m.

**Adoption of a draft UNCITRAL Legislative Guide
on Secured Transactions and possible future work**

(A/CN.9/617, 620, 631 and Add. 1-11, and 637 and
Add.1-8; A/CN.9/XL/CRP.10 and 11 and Add.1)

(continued)

*Chapter VI: The registry system (A/CN.9/631/Add.3
and 637) (continued)*

*Recommendations (recommendations 54 to 72)
(A/CN.9/637) (continued)*

Recommendations 61 and 62 (continued)

1. **The Chairperson** said that she had reviewed the policy considerations that had led Working Group VI (Security Interests) to include recommendation 62 in the draft Guide. One consideration had been the need to balance the interests of different parties and another to maintain the integrity of the registry system. If the interest of the transferee was allowed to prevail over that of the original secured creditor, it would greatly undermine the integrity of the registry system. Those policy considerations should be taken into account in any proposal to amend or delete the recommendation. She drew attention in that connection to recommendation 31 (Continued third-party effectiveness after a transfer of the encumbered asset), which stated the default rule. If recommendation 62 were to be deleted, the rights of the original secured creditor would prevail pursuant to recommendation 31. However, it had been agreed in the discussion at the previous meeting that a buyer, a transferee or the secured creditor of a transferee should also be afforded some protection.

2. **Mr. Riffard** (France) said that, in his view, it was impossible to provide a satisfactory answer to the question raised in a grantor-based registry system. The task before the Commission was to balance the interests of two innocent parties: the

original secured creditor of the grantor, which was perhaps unaware of the transfer of the encumbered asset, and a subsequent purchaser from or secured creditor of the transferee that had no way of obtaining knowledge of the transfer from the registered notice. None of the three possible solutions was satisfactory. The first solution was to ensure that the interests of the secured creditor prevailed because it should not suffer the consequences of the debtor's fraudulent conduct. A second was to protect a third party that was acting in good faith and that could not have obtained knowledge of the security right. The third solution, which might at first glance seem to be an acceptable compromise, consisted in requiring the grantor to inform the secured creditor of the transfer so that the latter could then amend the registered notice. Unfortunately, that solution had to be rejected on reflection because, on the one hand, it was unrealistic inasmuch as the grantor had already breached its contractual obligation to retain possession of the encumbered asset. On the other hand, it was unclear what kind of amendment should be made by the secured creditor when it learned of the transfer. The name of the grantor could not be amended without undermining the integrity of the registry system.

3. It followed that legislators would be faced with a policy decision as to whether the law should protect the secured creditor or third parties acting in good faith. States with civil law systems would tend to give precedence to third parties, but legislators should remain free to decide. He therefore proposed deleting recommendation 62 and discussing the options instead in the commentary, emphasizing that although the issue was theoretically important, it rarely arose in practice.

4. **Mr. Bazinas** (Secretariat) asked whether the representative of France had reservations regarding the requirement for the grantor to inform the secured

party because a breach of that obligation would create a contractual cause of action.

5. **Ms. Stanivuković** (Serbia) said that if recommendation 62 were to be deleted, it would also be necessary to delete recommendation 61 since they were both designed to protect the good faith of third parties that had relied on information contained in the registry.

6. The protected person in recommendations 61 (a) and 62 (a) was a subsequent secured creditor that was unaware of the existence of an earlier security right because it relied on the result of a registry search, and the protected person in recommendations 61 (b) and 62 (b) was a subsequent buyer. Deletion of the two recommendations would undermine the registry system. If the sale was made in the ordinary course of business, the buyer did not need to check the registry because it would obtain ownership without the security right. If the sale was not made in the ordinary course of business, there was no point in checking the registry because no amendment had been made. She therefore proposed retaining the two recommendations but placing an obligation on the grantor and transferee rather than on the secured creditor and including a provision regarding liability for damages. The chapeau of recommendation 62 would then read:

“The law should provide that, if, after a notice is registered, the grantor transfers the encumbered asset, the grantor and the transferee have a duty to amend the registered notice, changing the identifier of the grantor to the name of the transferee. The secured creditor may also make such an amendment. If no amendment is made within [a short period of time to be specified] days after the transfer, the security right is ineffective against: ...”

Subparagraphs 62 (a) and 62 (b) would remain unchanged and the following sentence would be added at the end of the recommendation:

“The grantor and the transferee shall be jointly and severally liable to the secured creditor for any damages arising from their failure to register the amendment referred to in this recommendation.”

7. **The Chairperson** noted that the proposed amendment would convert the secured creditor’s

interest into a right of action against the grantor and the transferee.

8. **Ms. Deschamps** (Canada) said he agreed that recommendations 61 and 62 should be considered jointly.

9. In reply to a question raised by the representative of France, he said that in the case of recommendation 61, the secured creditor would be required to amend the registered notice to indicate the new identifier of the grantor. In the case of recommendation 62, it would indicate that the asset was now owned by the transferee.

10. He was in favour of retaining recommendations 61 and 62 on condition that the time period for amendment of the registration began on the date on which the secured creditor acquired knowledge of the change. The practice currently followed in Canada was similar to that contemplated in recommendation 62. Transferees or prospective lenders to transferees advised the original secured creditor of the transfer and were then assured of acquiring title free of the previous encumbrance in the absence of an amendment to the registered notice within a fixed number of days. That *modus operandi* was considered in some cases to be simpler than obtaining a discharge from the previous secured creditor, which could often prove cumbersome.

11. **Mr. Voulgaris** (Greece) said that recommendation 62 was illogical and, even if amended, would not be accepted by States. A secured creditor that had correctly registered an asset could not be required, on account of the misconduct of a grantor, to forfeit its rights or to play the role of a detective. It should be left to ordinary law to establish which party was liable for the damages sustained.

12. **Mr. Umarji** (India) drew attention to recommendation 76 concerning priority in the event of transfer, which protected the secured creditor. He noted that the grantor’s obligation to inform was also applicable in the case of recommendation 61. In India, for example, where two companies planned a merger and both had borrowed against the security of their assets, the merger could not take place without the approval of the secured creditors.

13. **Mr. Sigman** (United States of America) said that his delegation continued to support the deletion of recommendation 62 in the interests of keeping the draft Guide as simple as possible and producing the cheapest credit available in the most efficient manner. The representative of France had ably stated the arguments in support of that position. It was not an issue of the integrity of the registry but of its utility. Secured creditors were assured that if they registered accurately and in a timely manner they would be protected. Integrity did not mean that a searcher should be able to obtain complete answers to every possible question in all circumstances. Where a grantor transferred an encumbered asset and the transferee made a further transfer, the subsequent buyer or lender was actually a fourth party which had a duty of due diligence to clarify the chain of title. No new burdens were imposed and there was no question of the registry being inaccurate.

14. A provision regarding liability for damages would serve no purpose, especially in the event of the grantor's insolvency. Grantors or transferees that were not acting in good faith would be liable in any case under other legislation.

15. **The Chairperson**, reviewing the options before the Commission, said that strong grounds would need to be invoked in order to amend provisions that had been discussed at length in the Working Group and that had already been reviewed by the Commission. There seemed to be a consensus that recommendation 62 was not entirely satisfactory but, as the representative of France had noted, there seemed to be no perfect solution to the problem. At the same time, a number of delegations were opposed to the deletion of recommendation 62. As concern had been expressed about the burden of monitoring placed on the original secured creditor, it had been suggested that the grantor and the transferee should be required to inform the secured creditor of any transfer. Such an obligation had, however, been deemed unrealistic inasmuch as the grantor was in most cases already breaching the terms of the security agreement by transferring the asset. Another option was to require the original secured creditor to amend the registered notice only where it acquired knowledge or had been notified in writing of the transfer. In all other cases its interests would continue to be protected. Some speakers had

noted that it was in the interest of the transferee and the transferee's secured creditor to ensure that the grantor's secured creditor was informed. She asked whether the Commission was prepared to accept that option.

16. **Mr. Smith** (United States of America) said that if deletion was not an option, his delegation would prefer to retain recommendation 62 as it stood since a knowledge test would merely create grounds for litigation. He pointed out that the recommendation in its current form would protect subsequent parties.

17. **Mr. Schöfisch** (Germany) said that his delegation would have preferred to delete recommendation 62. He agreed with the point made by the United States regarding the knowledge test. For instance, if the secured creditor acquired knowledge only one year after the transfer had occurred, there would be considerable uncertainty regarding the situation during the intervening period. By way of a compromise, however, his delegation would be prepared to support an amendment along the lines of that proposed by the delegation of Canada.

18. **Mr. Patch** (Australia) said that the secured creditor's interests should be protected until it acquired knowledge of the transfer. However, he opposed the idea of requiring the grantor or the transferee to give notice to the secured creditor. Although there was a contest between two innocent parties, the original secured creditor lost its innocence once it became aware of the transfer and failed to amend the registered notice. He supported the compromise proposed by the representative of Canada.

19. **Mr. Macdonald** (Canada) said that it was a principle of the draft Guide that the secured creditor retained a right in the proceeds of disposition of an asset subject to a security right. However, if the original secured creditor could always assert its right against transferred assets, regardless of the hands into which they passed, nobody would ever be able to lend on any asset unless it had precise knowledge of the history of the asset. The purpose of the rule proposed by Canada was to make it possible for the secured creditor to protect itself when knowledge was acquired but also to make it possible for a transferee to use the value of an asset

that it acquired to sustain a loan from its own creditor. He proposed that the commentary should set out all the competing policies in detail.

20. **Mr. Bazinas** (Secretariat) suggested adopting written notification of the original secured creditor as the rule in both recommendations 61 and 62. The subjective aspect of the issue of acquisition of knowledge would thus be avoided and the interests of innocent parties would be balanced.

21. **Mr. Voulgaris** (Greece) said that if the proposal to delete recommendation 62 was unacceptable, he would support any alternative solution only if it was workable.

22. **Mr. Fall** (Senegal) pointed out that the term “transfer” was somewhat vague in legal terms. In principle, if an asset was encumbered, the grantor was not entitled to effect a transfer during the period of registration. If the implications of recommendation 62 could not be clarified, his delegation would prefer to delete it.

23. **The Chairperson** said that the commentary should set out the different policy considerations and recognize the difficulties involved in reconciling conflicting interests.

24. The Commission needed to consider not only how the recommendations in the draft Guide might be reflected in legislation but also how they would work in practice. A mechanism that protected all parties’ interests would be based on a combination of legislation, the operation of the registry and action by the parties themselves. Commercial parties clearly had an interest in avoiding litigation by taking a simple step that would ensure protection of their rights. It was thus in the interest of the transferee to ensure that the secured creditor had knowledge of the transfer. No support had been expressed for the option of a written notification requirement but she again invited the Commission to consider a compromise solution involving a knowledge test.

25. **Mr. Weise** (Observer for the American Bar Association), referring to the question of whether recommendations 61 and 62 should be treated in the same way, said that it was far less difficult and costly for the grantor’s secured creditor to find out about a change of name under recommendation 61 than to ascertain whether its grantor had transferred

the encumbered asset. Hence it did not necessarily follow that the balance of equity determined for recommendation 62 would also be applicable to recommendation 61.

26. **Mr. Cercone** (Italy) suggested that, in the absence of a balanced solution, the Commission should recognize the existence of a trade-off and offer States a number of options from which to choose.

27. **The Chairperson** said that, if she heard no objection, she would take it that the Commission wished to amend recommendation 62 to state that the law should address the issue. The commentary would then spell out the advantages and disadvantages of the different policy options.

28. *Recommendation 62 was adopted on that understanding.*

29. **Mr. Smith** (United States of America), supported by **Mr. Umarji** (India) noted that the policy issues discussed in recommendation 62 were equally applicable to recommendation 61. Where an encumbered asset existed at the time of a change in the grantor’s identifier, the effect was the same as if the grantor had transferred the asset. He therefore proposed leaving recommendation 61 unchanged with respect to future assets but making it clear in the commentary that the same points regarding policy options were applicable to existing assets at the time of change of the identifier.

30. **Ms. Kaller** (Austria) expressed support for the proposal to leave recommendation 61 unchanged. It was important to ensure that prospective secured creditors were able to find the grantor’s identifier. In recommendation 62, on the other hand, a transferee that failed to consult the registry and find a prior security right would be at fault.

31. **Ms. Walsh** (Canada) said that the person protected under recommendation 62 was not the initial transferee, which should have searched the registry, but the secured creditor or buyer that subsequently dealt with the transferee. The issue of whether recommendation 61 should be treated differently should, in her view, be addressed from the standpoint of the monitoring burden. Her delegation was not averse to leaving the recommendation unchanged but it would not support

the proposal to make a distinction between present and future assets.

32. **Ms. McCreath** (United Kingdom) said that it was difficult to decide how to address recommendation 61 without knowing the exact content of the commentary to recommendation 62. She proposed that the commentary to recommendation 61 should deal with the possible implications of the policy choices discussed in the commentary to recommendation 62.

33. **Ms. Walsh** (Canada) further proposed that the commentary should set out the rationale for the adoption of different approaches to recommendations 61 and 62.

34. **The Chairperson** said she took it that the Commission wished to leave recommendation 61 unchanged and to ensure that the commentary reflected the points made by the representatives of the United Kingdom and Canada.

35. *It was so decided.*

36. *Recommendation 61 was adopted.*

Recommendations 63 to 72

37. *Recommendations 63 to 72 were adopted.*

The meeting was suspended at 11 a.m. and resumed at 11.30 a.m.

Commentary to chapter VI: The registry system (A/CN.9/631/Add.3, paras. 1-92)

38. **Mr. Macdonald** (Canada) proposed including in the introduction (paras. 1 to 8) a more systematic explanation of why an entire chapter of the draft Guide was devoted to the registry system. It should clarify the difference between property and personal rights and explain why a registry system was an important mechanism for indicating the potential existence of rights in assets.

39. *It was so decided.*

40. **Ms. Walsh** (Canada) noted that, according to the second sentence of paragraph 8, the specific features of different models for implementing a registry system were reviewed in the various sections of chapter VI. However, the bulk of chapter VI was devoted to an examination of the diverse features of a notice-based general security

rights regime, while the comparison of alternative approaches to registration was confined to the earlier paragraphs. She therefore proposed amending the description of the content to state that the objective was to examine in detail the distinctive nature of a notice-based general security rights registry in light of the diversity of possible approaches.

41. *It was so decided.*

42. **Ms. Walsh** (Canada) said that the first sentence of paragraph 18, which *stated* that there were typically no restrictions on who was permitted to make a registration in States that adopted a notice registration system, implied that the principle of public access arose only in the context of notice-based registry systems, which was untrue. She proposed amending the paragraph and others elsewhere in the chapter to remove that implication.

43. *It was so decided.*

44. **Ms. Walsh** (Canada), referring to the first two sentences of paragraph 22, noted that States might have a legitimate concern about equality of access for users even in electronic systems. She proposed making that point clear in the text.

45. *It was so decided.*

46. **Ms. Walsh** (Canada) proposed moving the last sentence of paragraph 27 to paragraph 28, which summarized the draft Guide's position that public searching by the name of the secured creditor should not be permitted. It should, however, also be emphasized that States were permitted to build in a technical search functionality for internal purposes.

47. *It was so decided.*

48. **Ms. Walsh** (Canada) noted that paragraph 34 in the section of chapter VI concerning grantor as compared to asset indexing dealt with the possibility of building in a limited supplementary asset-based search capability in which searches could be conducted against, for instance, the serial number of assets such as road vehicles. She proposed expanding the commentary to emphasize the need for certain qualifications where such a capability was established. For instance, the numerical identifier of the asset had to be unique and reliable. Moreover, searching should be restricted to

relatively high-value assets for which there was a significant resale market.

49. *It was so decided.*

50. **The Chairperson** drew attention to a note by the Secretariat following paragraph 34 inviting the Commission to consider whether the rule stated in the last sentence, namely that the mandatory requirement for serial number identification should be limited to cases where the serially numbered property was not held as inventory, should be reflected in a recommendation.

51. **Ms. Walsh** (Canada) noted that the draft Guide did not contain any recommendation dealing with supplementary asset-based searching. She therefore proposed confining the rule stated in paragraph 34 to the commentary.

52. *It was so decided.*

53. **Ms. Walsh** (Canada) noted that the Commission had decided in chapter IV concerning the creation of a security right (effectiveness as between the parties) that the commentary should strike an appropriate balance in its discussion of the advantages and disadvantages of requiring that a maximum amount of the secured obligation be stated in the registered notice. There was a similar problem of balance in paragraphs 57 and 58. Part of the problem seemed to stem from the reference in the comparison between the two approaches to some States' position that it was not possible to secure future obligations. The draft Guide rejected that position absolutely and it should make that point separately. A comparison should be made solely between, on the one hand, the approach that allowed future obligations but did not require specification of a maximum amount and, on the other, the approach that allowed future obligations but required the parties to state a maximum amount without otherwise restricting their rights. She proposed amending the commentary to ensure a more balanced discussion of those points.

54. *It was so decided.*

55. **Mr. Macdonald** (Canada) noted that paragraph 66 contained a brief discussion of the distinction between natural and legal persons. He proposed expanding the commentary to discuss the status of a person that was operating a partnership or

conducting business in a name other than the personal identifier of the grantor.

56. *It was so decided.*

57. **The Chairperson** noted that paragraphs 67 to 69 of the commentary would need to be expanded to reflect the decisions just taken regarding recommendations 61 and 62.

58. *The substance of the commentary to chapter IV was approved subject to the agreed amendments.*

Revisions to and reordering of the introduction, chapter I (Key objectives) and section C of chapter II (Scope of application and other general rules) (A/CN.9/631/Add.1 and 637 and A/CN.9/XL/CRP.11)

59. **The Chairperson** drew attention to document A/CN.9/XL/CRP.11, which contained proposals for reordering and revising the following material contained in document A/CN.9/631/Add.1: the introduction, chapter I (Key objectives) and section C of chapter II (Scope of application and other general rules). The revised material would form part of a new introduction to the draft Guide.

60. **Mr. Bazinas** (Secretariat) said that the purpose of document A/CN.9/XL/CRP.11 was to make the draft Guide more user-friendly, particularly for readers in jurisdictions that had a different secured transactions law from that recommended. It did not replace the whole of document A/CN.9/631/Add.1 but restructured its content and added material to provide for a smooth transition from general to specific information.

61. Section A of the new introductory chapter, which stated the purpose of the draft Guide, remained unchanged from the original introduction. Section B brought forward the examples of financing practices covered in the draft Guide that had originally been contained in section C of chapter II (paras. 57 to 77 of document A/CN.9/631/Add.1). Section C, entitled "Key objectives and fundamental principles of an effective and efficient secured transactions regime" incorporated the material originally contained in chapter I (paras. 20 to 31 of document A/CN.9/631/Add.1) as well as additional material. The purpose of the section was to provide a bridge between the general objectives of the draft Guide and the detailed recommendations by setting out

certain fundamental principles of a modern secure transactions system, such as comprehensive scope, the integrated and functional approach, and security rights in future assets. A new section D entitled “Implementing a new secured transactions law” was intended to provide guidance to national legislators on the different ways in which the recommendations in the draft Guide could be implemented, taking into account existing legislation, legislative methods and drafting techniques. It also emphasized the need for dissemination of information to lawyers, judges and practitioners who would be called upon to implement the law. Section E contained the terminology set out in document A/CN.9/637 and section F contained recommendation 1.

62. **The Chairperson** said she took it that the Commission agreed to the proposed revision and reordering of the material, which now constituted a new introductory chapter.

63. *It was so decided.*

Introduction (A/CN.9/631/Add.1 and 637 and A/CN.9/XL/CRP.11)

Introduction: section A: Purpose of the Guide (A/CN.9/631/Add.1, paras. 1-12)

64. *The substance of section A was approved.*

Introduction: section B: Examples of financing practices covered in the Guide (A/CN.9/631/Add.1, paras. 57-77, to be renumbered 13-33)

65. *The substance of section B was approved.*

Introduction: section C: Key objectives and fundamental principles of an effective and efficient secured transactions regime (A/CN.9/XL/CRP.11, paras. 34 to 62)

66. **Ms. Walsh** (Canada) proposed adding a key objective concerning the need to harmonize secured transactions law and insolvency law.

67. In response to a question from **Mr. Bazinas** (Secretariat), **Ms. Walsh** (Canada) confirmed that it would be acceptable instead to incorporate that point in objective (j) entitled “To balance the interests of affected persons”.

68. *It was so decided.*

69. **Mr. Riffard** (France) noted that the second last sentence of paragraph 53 concerning the integrated and functional approach seemed, in its current form, to advocate the unitary approach and rule out the non-unitary approach. He therefore proposed amending it to read: “... to the maximum extent possible, all transactions that create a right in all types of asset meant to secure the performance of an obligation ... should be considered as security rights and regulated by the same rules or, at least, the same principles”.

70. **Mr. Macdonald** (Canada) expressed support for the proposed amendment. It would be useful to signal the existence of a bifurcated approach to acquisition financing at an early stage in the draft Guide.

71. *It was so decided.*

72. **Ms. Okino Nakashima** (Japan) said that she had some difficulty in understanding the relationship between the heading of paragraph 58, “Priority among multiple security rights”, and the first two sentences, which emphasized the importance of the availability of multiple security rights in the same movable asset. She suggested that the title should cover both the need for a clear priority rule and the importance of the availability of multiple security rights.

73. **Mr. Macdonald** (Canada) said that the distinction noted by the representative of Japan was of such importance that it might be preferable for the commentary to discuss separately the significance of multiple security rights and the importance of establishing a clear priority rule governing such rights.

74. *It was so decided.*

75. **Ms. Walsh** (Canada) noted that paragraph 61 provided two examples of cases in which extrajudicial enforcement was traditionally permitted. The example of pawnbrokers was correct but that of creditors holding general company security rights was, in her view, inaccurate. She proposed that it be deleted.

76. *It was so decided.*

77. **Ms. Walsh** (Canada) drew attention to the second last sentence of paragraph 62 concerning equal treatment of sellers and lenders, which stated

that retention-of-title sellers would be able to benefit from the complete range of rights given to secured creditors, which in some ways exceeded the rights available to retention-of-title sellers under existing law in most States. She considered that statement to be inaccurate inasmuch as sellers, by virtue of their retained ownership, were just as frequently given rights that exceeded those of traditional secured creditors. She therefore proposed deleting the sentence.

78. **Mr. Bazinas** (Secretariat) said that the sentence had been included because the recommendations in the draft Guide would provide retention-of-title sellers with security rights that enjoyed priority if registration took place within a grace period after delivery of the goods. They would also enjoy a security right in the proceeds of assets, with the exception of cash proceeds, and the draft Guide's conflict-of-law recommendations provided for cross-border recognition of the security right.

79. **Ms. Walsh** (Canada) noted that cash proceeds, receivables and bank deposits would all be excluded. It was therefore somewhat imbalanced to suggest that retention-of-title sellers would enjoy new rights. The fundamental principle stated in paragraph 62 was that all creditors that provided credit to enable grantors to acquire tangible assets should be treated equally.

80. **Mr. Umarji** (India) expressed support for the proposal by the representative of Canada.

81. **The Chairperson** said that, if she heard no objection, she would take it that the Commission wished to delete the second last sentence of paragraph 62.

82. *It was so decided.*

83. *The substance of section C was approved subject to the agreed amendments.*

Introduction: section D: Implementing a secured transactions law (A/CN.9/XL/CRP.11, paras. 63 to 79)

84. *The substance of section D was approved.*

Introduction: section E: Terminology (A/CN.9/637, paras. 1-6, renumbered as paras. 80-85)

85. **The Chairperson** drew attention to a note to the Commission at the beginning of the terminology section in document A/CN.9/637 regarding a proposal made earlier in the session to reproduce the terminology and all recommendations in a separate appendix to the draft Guide.

86. **Mr. Smith** (United States of America) and **Mr. Umarji** (India) expressed support for that proposal.

87. *It was so decided.*

The meeting rose at 12.30 p.m.

**Summary record of the 858th meeting, held at the Vienna International Centre
on Tuesday, 11 December 2007, at 2 p.m.**

[A/CN.9/SR.858]

Chairperson: Ms. Sabo (Canada)

The meeting was called to order at 2.10 p.m.

Adoption of a draft UNCITRAL Legislative Guide on Secured Transactions and possible future work (A/CN.9/617, 620, 631 and Add. 1-11, and 637 and Add.1-8; A/CN.9/XL/CRP.10 and 11 and Add.1) (continued)

Introduction (A/CN.9/631/Add.1 and 637 and A/CN.9/XL/CRP.11) (continued)

Introduction: section E: Terminology (A/CN.9/637, paras. 1 -6, renumbered as paras. 80-85) (continued)

1. *The substance of section E was approved.*
2. *The substance of the commentary to the new introductory chapter as a whole was approved, subject to the agreed amendments.*

Recommendation 1 (A/CN.9/637)

3. *Recommendation 1 was adopted.*

Revisions to and reordering of chapters II and III (A/CN.9/631/Add.1 and 637 and A/CN.9/CRP.11/Add.1)

4. **Mr. Bazinas** (Secretariat) said that document A/CN.9/CRP.11/Add.1 contained a proposal to revise and reorder chapter II on the scope of application and other general rules and chapter III on basic approaches to security, as set out in document A/CN.9/631/Add.1, and to combine them in a new chapter I entitled "Scope of application and basic approaches to secured transactions". Section A on the scope of application reproduced the corresponding section of chapter II in document A/CN.9/631/Add.1 with some modifications and additions aimed at reflecting decisions taken earlier in the session. Section B on basic approaches to security reproduced paragraphs 78 to 141 of document A/CN.9/631/Add.1 containing chapter III with some minor amendments. Section C entitled "Two key themes common to all chapters of the Guide" was based on section B of chapter II

concerning party autonomy and electronic communications.

5. **The Chairperson** said she took it that the Commission agreed to the proposed revision and reordering of the material, which now constituted a new chapter 1.

6. *It was so decided.*

Commentary to chapter I (A/CN.9/631/Add.1 and 637 and A/CN.9/XL/CRP.11/Add.1)

Section A: Scope of application (A/CN.9/XL/CRP.11/Add.1, paras. 86-122)

7. **Ms. McCreath** (United Kingdom), referring to paragraph 118, reminded the Commission of her delegation's position that security rights in payment rights arising under or from a financial contract should be excluded from the draft Guide regardless of whether the financial contract was governed by a netting agreement.

8. *The substance of section A was approved.*

Section B: Basic approaches to security (A/CN.9/631/Add.1, paras. 78-141, to be renumbered as 123-186, and A/CN.9/XL/CRP.11/Add.1)

9. **Mr. Macdonald** (Canada) proposed adding a sentence here and there throughout the section in order to provide a historical context and explain as fully as possible the rationale for the adoption of different approaches to security rights over time.

10. *It was so decided.*

11. *The substance of section B was approved on that understanding.*

Section C: Two key themes common to all chapters of the Guide (A/CN.9/XL/CRP.11/Add.1, paras. 187-196)

12. *The substance of section C was approved.*

13. *The substance of the commentary to new chapter I as a whole was approved, subject to the agreed amendments.*

Recommendations 2 to 12 (A/CN.9/637)

Recommendations 2 to 6

14. *Recommendations 2 to 6 were adopted.*

Recommendation 7

15. **Mr. Bazinas** (Secretariat), referring to the note from the Secretariat following recommendation 7, said that a previous version of the recommendation had recommended excluding security rights in employment benefits. However, the Commission had taken a policy decision to avoid mentioning examples of practices that should be excluded lest it encourage States to restrict the scope of application of the law. The first sentence of recommendation 7 now simply stated that the law should not include other limitations to its scope of application, and the second sentence urged legislators that decided to introduce additional limitations to spell them out clearly in the law. The latter wording was based on a recommendation regarding privileged claims that had already been adopted.

16. **Mr. Burman** (United States of America) expressed support for the new version of the recommendation.

17. *Recommendation 7 was adopted.*

Recommendations 8 to 12

18. *Recommendations 8 to 12 were adopted.*

Chapter XI: Acquisition financing (A/CN.9/637 and Add.5)

Recommendations (recommendations 174-199) (A/CN.9/637)

19. **The Chairperson** noted that the Commission had adopted most of the recommendations relating to chapter XI concerning acquisition financing during the earlier part of the session. However, some outstanding issues needed to be settled.

Recommendations 176, 182, 189 and 196

20. **Mr. Bazinas** (Secretariat) noted that the Commission had agreed earlier in the session that alternative approaches to the priority position applicable to an acquisition security right or an acquisition financing right in tangible property should be offered in sections A and B of chapter XI (the unitary and non-unitary approaches). Alternative A in recommendation 176 in the section on the unitary approach drew a distinction between inventory and tangible assets other than inventory. The rule in the case of the latter was that the acquisition secured creditor would have to register within a grace period after delivery of the tangible assets in order to obtain priority. In the case of inventory, two conditions had to be met to secure priority: (a) registration of a transaction in the general security rights registry prior to delivery of the inventory to the grantor; and (b) notification of inventory financiers, since they would otherwise have to check the registry upon each delivery cycle in order to ensure that their priority had not changed. Alternative B made no distinction between inventory and goods other than inventory. It merely stated that an acquisition secured creditor obtained priority if it registered a notice about the transaction in the general security rights registry within a certain period of time after delivery of the tangible assets. Recommendation 189 offered similar alternatives with respect to the non-unitary approach.

21. Notes following recommendations 182 and 196 raised the question of whether the Commission wished to adopt the same approach in the case of acquisition security rights in proceeds.

22. **Mr. Schöfisch** (Germany) expressed support for recommendations 176 and 189 and for the proposals made in the notes following recommendations 182 and 196.

23. **Mr. Smith** (United States of America) expressed opposition to the proposals to extend super-priority to the proceeds of inventory since it would discourage receivables financing.

24. **Mr. Bazinas** (Secretariat) said while an acquisition security right would have special priority in the original collateral, the right in the

proceeds would be a normal security right without special priority.

25. **Mr. Smith** (United States of America) withdrew his objection.

26. *Recommendations 176 and 189 and the new recommendations suggested in the notes to recommendations 182 and 196 were adopted.*

Placement of recommendations 183 and 198

27. **Mr. Bazinas** (Secretariat) said that recommendations 183 and 198 dealt with the treatment of acquisition security rights, in the case of the unitary approach, and retention-of-title or financial lease rights, in the case of the non-unitary approach, in insolvency proceedings. Concern had been expressed that the placement of those recommendations in the chapter on insolvency might give the impression that the characterization of acquisition financial transactions as security or ownership devices was a matter of insolvency law, a position that would be inconsistent with the UNCITRAL Legislative Guide on Insolvency Law. The recommendations had therefore been moved to the chapter on acquisition financing.

28. **The Chairperson** said she took it that the Commission approved the decision to place recommendations 183 and 198 in chapter XI.

29. *It was so decided.*

Recommendation 178

30. **Mr. Bazinas** (Secretariat) drew attention to a note following paragraph 178 of the commentary to the chapter on acquisition financing (document A/CN.9/637/Add.5) concerning recommendation 178, which dealt with priority between competing acquisition security rights and gave priority to a supplier's right over that of a lender. The note invited the Commission to consider whether a recommendation along similar lines should be included in the non-unitary approach section of chapter XI. Alternatively, the commentary could explain that in the context of the non-unitary approach a retention-of-title seller or a financial lessor would always have priority by virtue of its ownership rights.

31. **Mr. Macdonald** (Canada) said that the principle set out in recommendation 178 was applicable as a matter of course in the non-unitary approach because of the seller's retention of title. An additional recommendation was therefore unnecessary, but he proposed making it clear in the commentary that it flowed from the concept of ownership that the right of a retention-of-title seller would have priority over an acquisition security right granted by the buyer.

32. **Mr. Schneider** (Germany) expressed support for that proposal.

33. **The Chairperson** said that, if she heard no objection, she would take it that the Commission agreed that it was unnecessary to insert an additional recommendation but that the commentary should be expanded to reflect the point made by the representative of Canada.

34. *It was so decided.*

Recommendation 193

35. **Mr. Bazinas** (Secretariat) drew attention to a note following paragraph 182 of the commentary to the chapter on acquisition financing (document A/CN.9/637/Add.5) inviting the Commission to consider whether it should add a recommendation along the lines of recommendation 193 (Existence of a security right in proceeds of a tangible asset subject to a retention-of-title or financial lease right) to address cases in which a retention-of-title seller or a financial lessor was deprived of its rights of ownership. For instance, where the seller of an asset that became an attachment to immovable property was not registered in a timely way, the seller or lessor would lose its ownership rights. As noted in paragraph 182 of the commentary, however, once third-party effectiveness was achieved, the seller or lessor could claim an ordinary security right.

36. **Mr. Schneider** (Germany) said that the issue raised in paragraph 182 was very important in practice. He was in favour of inserting a new recommendation to address the point.

37. **Mr. Smith** (United States of America) said that he was not convinced of the need for a recommendation since a retention-of-title right would automatically be converted into a normal security right under the circumstances.

38. **Mr. Macdonald** (Canada) proposed separating paragraph 182 from the preceding paragraphs, giving it a title and expanding its content. He was also in favour of adding a recommendation because, unlike in the previous case, it did not follow as a matter of course in the case of an attachment to immovable property that a retention-of-title right would be converted into a security right.

39. **Mr. Smith** (United States of America) withdrew his objection to the inclusion of a new recommendation.

40. **The Chairperson** said she took it that the Commission wished to insert a new recommendation along the lines of that suggested in the note following paragraph 182 of the commentary.

41. *It was so decided.*

Commentary to chapter XI: Acquisition financing (A/CN.9/637/Add.5, paras. 118-182)

42. **The Chairperson** noted that the substance of the commentary to chapter XI had been approved during the first part of the session. It would be amended in the light of the decisions just taken.

43. *The substance of the commentary to chapter XI explaining the recommendations just adopted was approved.*

The meeting was suspended at 3.30 p.m. and resumed at 4.05 p.m.

Chapter X: Enforcement of a security right (A/CN.9/637 and Add.4 and A/CN.9/XL/CRP.10)

Recommendations (recommendations 128-173) (A/CN.9/637 and A/CN.9/XL/CRP.10)

44. **The Chairperson** noted that the recommendations pertaining to chapter X had already been adopted during the first part of the session. However, some changes might be necessary to address issues that had arisen when the commentary was being finalized by the Secretariat.

Recommendation 137

45. **Mr. Bazinas** (Secretariat) drew attention to the note following recommendation 137 concerning the extinction of a security right after full satisfaction of the secured obligation. The recommendation

currently stated that the right to satisfy a secured obligation in full could be exercised until the disposition, acceptance or collection of an encumbered asset by the secured creditor. The question raised in the note was whether the Commission wished to include text in square brackets covering the situation in which a secured creditor had concluded an agreement to dispose of the encumbered asset before the actual disposition took place.

46. **Mr. Smith** (United States of America) expressed support for retention of the bracketed text. It was a common practice for the secured creditor to enter into a contract to dispose of an encumbered asset. In the absence of such a clause, dispositions might be discouraged and potential buyers might be unwilling to raise finance or to incur the cost of due diligence unless they were sure of being able to purchase the asset.

47. **Mr. Bazinas** (Secretariat) drew attention to a further amendment proposed in paragraph 19 of document A/CN.9/XL/CRP.10, namely to add the words “earlier of the” to the sentence containing the bracketed text, which would then read: “This right may be exercised until the earlier of the disposition, acceptance or collection of an encumbered asset by the secured creditor or the conclusion of an agreement by the secured creditor to dispose of the encumbered asset.”

48. **Mr. Sigman** (United States of America) expressed support for the amendment.

49. **The Chairperson** said that, if she heard no objection, she would take it that the Commission wished to retain the bracketed text and to add the clarification proposed in document A/CN.9/XL/CRP.10.

50. *Recommendation 137, as amended, was adopted.*

Recommendation 142

51. **Mr. Bazinas** (Secretariat) drew attention to a note following recommendation 142 concerning the right of a higher-ranked secured creditor to take over enforcement, in which the Secretariat suggested amending the text to add the same bracketed text as had just been adopted in the case of recommendation 137, namely “or the conclusion

of an agreement by the secured creditor to dispose of the encumbered asset". He further suggested inserting the words "earlier of the" at the appropriate point in the sentence.

52. **The Chairperson** said that, if she heard no objection, she would take it that the Commission wished to adopt the amendments suggested by the Secretariat.

53. *It was so decided.*

54. **Mr. Bazinas** (Secretariat) drew attention to a further issue raised in the note following recommendation 142, namely whether the collection of a receivable should be addressed instead in recommendation 164 in the section containing asset-specific recommendations with respect to the collection of receivables. The note to recommendation 164 included a draft recommendation based on the wording of recommendation 142 which addressed the application of the net proceeds of enforcement to the secured obligation. The second sentence of the text was intended to give protection to a secured creditor with higher priority than that of the enforcing secured creditor.

55. **Mr. Cohen** (United States of America) said that the fact that the secured creditor with higher priority was entitled to take over at any time before disposition or collection was a point that must be made explicit. The draft text in the note following recommendation 164 was similar to that contained in recommendation 149, which, as currently worded, did not state the right of the prior secured creditor to take over. Deletion of the phrase "or collection" in recommendation 142 would serve no purpose unless new language stating that right was added to either recommendation 149 or the draft text following recommendation 164.

56. **Mr. Macdonald** (Canada) expressed support for that position.

57. **The Chairperson** said she took it that the Commission wished to remove the square brackets from around the words "or collection" in recommendation 142.

58. *It was so decided.*

59. *Recommendation 142, as amended, was adopted.*

Recommendation 144

60. **Mr. Bazinas** (Secretariat) noted that the Commission had already agreed that a secured creditor could obtain possession of an encumbered asset extrajudicially only if three conditions were met: (a) that the grantor had consented to that approach in the security agreement; (b) that the secured creditor had given the grantor and any person in possession of the encumbered notice of default and of its intention to obtain possession extrajudicially; and (c) that the grantor raised no objection at the time when the secured creditor sought to obtain possession of the asset. A note by the Secretariat following the recommendation raised the question of whether those conditions needed to be met if the grantor and any other person in possession of the encumbered asset had affirmatively consented to extrajudicial repossession of the asset. If they did not, the Secretariat suggested inserting a sentence in the recommendation, which would become subparagraph (d), to that effect.

61. **Mr. Smith** (United States of America) and **Mr. Riffard** (France) expressed support for the addition of the text suggested by the Secretariat.

62. **Mr. Macdonald** (Canada) said that he also agreed in principle with the suggested amendment. However, he requested clarification of the practical implications of such a provision where, for instance, a subsequent creditor took a security right in the encumbered asset on the basis that there was no statement in the security agreement permitting extrajudicial enforcement.

63. **Mr. Smith** (United States of America) said that in practice other secured creditors tended to rely on receiving notice prior to a disposition by the secured creditor or prior to an acceptance by the secured creditor of the encumbered asset in satisfaction of the secured obligation, but they did not rely on the absence of a repossession clause in making their credit decisions.

64. **Mr. Morse** (Observer for the Commercial Finance Association) confirmed that the existence or otherwise of such a clause in a security agreement would normally have no bearing on a subsequent creditor's decision.

65. **Mr. Macdonald** (Canada) said that his delegation was reassured by the previous two statements.

66. **Mr. Umarji** (India) said that the requirement in subparagraph (b) of recommendation 144 that the secured creditor should give notice of default and of its intent to obtain possession extrajudicially should be retained in all circumstances. On receiving notice, the grantor might, for instance, wish to remedy the default and pay off the loan, which served the interests of the secured creditor. A notice was also necessary for other interested parties such as guarantors.

67. In response to a question from **Mr. Bazinas** (Secretariat), **Mr. Smith** (United States of America) said that his previous statement to the effect that secured creditors tended to rely on receiving notice prior to a disposition did not refer to the notice mentioned in subparagraph (b) of recommendation 144 but to the notice that any secured creditor gave to other secured creditors when it sold or otherwise disposed of an encumbered asset or agreed to accept the asset in satisfaction of a secured obligation. If a grantor affirmatively consented to the repossession, it should be irrelevant, in his view, whether the notice referred to in subparagraph (b) was given.

68. **Mr. Voulgaris** (Greece) said that he also saw no need for the prior notice referred to in subparagraph (b) if the grantor and any other person in possession of the encumbered asset indicated their consent explicitly at the time of extrajudicial repossession of the encumbered asset by the secured creditor. He not only supported the additional text suggested by the Secretariat but suggested that it might be recast in such a way as to replace the entire recommendation. He was not proposing to change the substance of recommendation 144 but simply to make the wording less cumbersome.

69. **Ms. Walsh** (Canada) said that if the aim of recommendation 144 was to protect the grantor, it should be sufficient if the grantor's consent was obtained at any time, including at the time of default, rather than in the security agreement, as proposed in subparagraph (a). She noted that the law was normally more suspicious of consent given in the security agreement, because a grantor requiring money would be prepared to consent to any condition at that stage. Moreover, if the reference to

the security agreement in subparagraph (a) was deleted, the additional text suggested by the Secretariat could be omitted.

70. **The Chairperson** pointed out that the text of the recommendation had been discussed at length by Working Group VI (Security Interests) and had already been adopted by the Commission during the first part of the session. As a compromise solution, she asked whether the additional text suggested by the Secretariat might be acceptable if it referred only to subparagraphs (a) and (c), so that the requirement in subparagraph (b) would still have to be met.

71. **Mr. Riffard** (France) said that he was in favour of inserting the additional text as subparagraph (d) without any amendment. He pointed out that recommendation 144 was not intended to address the issue of default under all circumstances but only in the event of repossession by the secured creditor of an encumbered asset held by the grantor or another person in possession. The question of whether it was necessary to notify other creditors in the event of default was addressed elsewhere in the draft Guide.

72. **Mr. Boulet** (Observer for Belgium) drew attention to recommendation 130, which entitled the grantor and any other person owing performance of a secured obligation to waive their rights unilaterally under the provisions on enforcement after default. He wondered whether it was necessary in the light of that recommendation to insert proposed subparagraph (d). Perhaps the rule should be mentioned instead in the commentary.

73. **Ms. Walsh** (Canada) concurred with that view. The only reason to restate the rule in recommendation 144 would be to ensure that it could not be argued after the fact that consent had been obtained through an abuse of good faith.

74. If the Commission decided to insert new subparagraph (d) concerning affirmative consent, it was somewhat illogical to state that the requirement of subparagraph (c) was no longer applicable inasmuch as the latter referred to non-objection on the part of the grantor.

75. **Mr. Riffard** (France) said that he also agreed with the point made by the representative of Belgium. However, he was in favour of restating the

rule in recommendation 144 so that the situation was absolutely clear.

76. **Ms. Walsh** (Canada) pointed out that if the rule in recommendation 130 was restated in recommendation 144, it should also be restated in the case of other analogous recommendations in which there was no explicit reference to waiver of rights. She therefore supported the proposal to leave the text of recommendation 144 unchanged and to discuss the content of proposed subparagraph (d) in the commentary.

77. **The Chairperson** invited the Commission to review the various options before resuming the discussion at its next meeting.

The meeting rose at 5.05 p.m.

**Summary record of the 859th meeting, held at the Vienna International Centre
on Wednesday, 12 December 2007, at 9.30 a.m.**

[A/CN.9/SR.859]

Chairperson: Ms. Sabo (Canada)

The meeting was called to order at 9.40 a.m.

Adoption of a draft UNCITRAL Legislative Guide on Secured Transactions and possible future work (A/CN.9/617, 620, 631 and Add. 1-11, and 637 and Add.1-8; A/CN.9/XL/CRP.10 and 11 and Add.1) *(continued)*

Chapter X: Enforcement of a security right (A/CN.9/637 and Add.4) *(continued)*

Recommendations (recommendations 128-173) (A/CN.9/637) *(continued)*

Recommendation 144 (continued)

1. **The Chairperson** said that she took it, in light of the discussion at the previous meeting that the Commission wished to reflect the content of the Secretariat's note following recommendation 144 in the commentary to chapter X.

2. *It was so decided.*

3. **The Chairperson** drew attention to the suggestion in the same note that subparagraph (c) of recommendation 144 should refer not just to the grantor but also to the person in possession of the encumbered asset.

4. **Mr. Macdonald** (Canada) expressed support for that amendment because the main purpose of the provision was to permit extrajudicial enforcement without a breach of the peace. The key actor envisioned by subparagraph (c) was therefore the person in possession of the encumbered asset.

5. **The Chairperson** said that, if she heard no objection, she would take it that the Commission wished to amend subparagraph (c) to reflect the suggestion made in the Secretariat's note.

6. *It was so decided.*

7. *Recommendation 144, as amended, was adopted.*

Recommendation 148

8. **The Chairperson** drew attention to the Secretariat's note following recommendation 148, which invited the Commission to consider whether subparagraph (c) of the recommendation should be amended to bring it into line with article 16 (1) of the United Nations Convention on the Assignment of Receivables in International Trade (United Nations Assignment Convention). It was suggested that the following sentence should be added to the subparagraph: "It is sufficient if the notice is in the language of the security agreement being enforced."

9. **Mr. Ginting** (Observer for Indonesia) said that it would be more equitable for both the grantor and the secured creditor if the notice were drawn up in the language of the security agreement being enforced.

10. **Mr. Cohen** (United States of America) pointed out that article 16 (a) of the United Nations Assignment Convention dealt only with a notice to a debtor that had entered into an agreement in the language concerned. A parallel provision in recommendation 148 should therefore state that it was sufficient if the notice "to the grantor" was in the language of the security agreement being enforced. The other recipients of the notice might have been dealing in a language other than that of the security agreement.

11. **Mr. Macdonald** (Canada) said that he agreed with the point just made. For instance, a debtor in France that had signed a security agreement in English with a creditor in the United Kingdom might have signed other security agreements in France with parties that had an interest in the same property but did not do business in English. It was a reasonable assumption that those parties were also entitled to receive notices in a language that they understood.

12. **Mr. Bazinas** (Secretariat) noted that subparagraph (a) of recommendation 148 listed all parties to whom notice must be given. It could perhaps be assumed that third-party secured creditors with rights in the encumbered asset would make a point of checking the content of the security agreement with the grantor.

13. **The Chairperson** pointed out that the first sentence of subparagraph (c), which stated that notice must be provided in a language that was reasonably expected to inform its recipients about its contents, would cover the case of third parties.

14. **Mr. Cohen** (United States of America), referring to the example provided by the representative of Canada, said that the parties referred to in subparagraph 148 (a) (iii), namely other secured creditors that registered a notice with respect to a security right in the encumbered asset, would in that case have registered in France where the grantor was located. While they would certainly have checked the registry, it was unlikely that they would have been given access to the security agreement, which was a private document, and they would therefore be unaware of the language in which it was drafted.

15. **Mr. Voulgaris** (Greece) said that he had reservations concerning the addition of the sentence suggested by the Secretariat, since other concerned parties might not be familiar with the language of the security agreement. Even if it was amended as proposed by the delegation of the United States, the grantor might not be assured of receiving the notice in due time if, under the rules of civil procedure, it had to be provided in the local language. However, he was willing to go along with whatever the Commission decided in that regard.

16. **The Chairperson** said she took it that the Commission agreed to add the sentence suggested by the Secretariat, which would be amended to read: "It is sufficient if the notice to the grantor is in the language of the relevant security agreement."

17. *It was so decided.*

18. *Recommendation 148, as amended, was adopted.*

Recommendation 149

19. **Mr. Bazinas** (Secretariat) said that the Commission might wish to consider in the case of recommendation 149 whether the distribution of proceeds of the disposition of an encumbered asset, where it was a receivable, should be addressed in a separate recommendation along the lines of the text set out in the note following recommendation 164. The suggested text provided that the enforcing secured creditor must apply the net proceeds of its enforcement to the secured obligation, and that it must pay any surplus to competing claimants that had notified it of their claim to the extent of that claim. Any balance remaining would be remitted to the grantor. The sentence concerning competing claimants was designed to protect a secured creditor with higher priority status than the enforcing secured creditor. A senior secured creditor was protected because its security right in the asset disposed of continued.

20. **Mr. Ginting** (Observer for Indonesia), referring to the original text of recommendation 149, said that it was unclear whether it was the grantor or another party that notified the enforcing secured creditor. He also wished to know why the whole of the remaining surplus was not remitted by the enforcing secured creditor to the grantor instead of to any subordinate competing claimant, since there was no direct business between the secured creditor and that claimant.

21. **Mr. Bazinas** (Secretariat) said that the subordinate claimants would notify the enforcing secured creditor. With regard to the second question, he noted that recommendation 149 should be read in conjunction with recommendation 150, so that if the enforcing secured creditor was convinced that the subordinate claimants had a valid claim, it would pay the surplus to them. If there was any dispute as to their entitlement, it would pay the surplus, in accordance with generally applicable procedural rules, to a competent judicial or other authority or to a public deposit fund for distribution.

22. **The Chairperson** asked the Commission whether it wished to retain the phrase in square brackets in recommendation 149, which read "or collection of a receivable, negotiable instrument or other obligation".

23. **Mr. Umarji** (India) proposed replacing the bracketed text by the suggested new recommendation set out in the note following recommendation 164, which made a distinction between extrajudicial disposition of an asset and collection of a receivable.

24. **The Chairperson** said that, if she heard no objection, she would take it that the Commission wished to replace recommendation 149 with the new asset-specific recommendation set out in the note following recommendation 163.

25. *It was so decided.*

Recommendation 152

26. **The Chairperson** drew attention to the note by the Secretariat following recommendation 152, which suggested deleting the bracketed text “unless otherwise agreed” because party autonomy was already covered by recommendations 8 and 130. If she heard no objection, she would take it that the Commission agreed to the suggested deletion.

27. *It was so decided.*

28. *Recommendation 152, as amended, was adopted.*

Recommendation 163

29. **The Chairperson** drew attention to recommendation 163, which was enclosed in square brackets because it was a suggested new recommendation designed to address the issue of enforcement of a security right in an attachment to movable property. If she heard no objection, she would take it that the Commission agreed to include the new recommendation.

30. *Recommendation 163 was adopted.*

Recommendation 164

31. **Ms. Walsh** (Canada) proposed referring in recommendation 164 (a) not only to recommendation 128, which laid down the general standard of conduct in the context of enforcement, but also to recommendation 129, which stipulated that that standard of conduct could not be waived unilaterally or varied by agreement.

32. **The Chairperson** said that, if she heard no objection, she would take it that the Commission agreed to add a reference to recommendation 129.

33. *It was so decided.*

34. *Recommendation 164, as amended, was adopted.*

Commentary to chapter X: Enforcement of a security right (A/CN.9/637/Add.4)

35. **The Chairperson** noted that the substance of the commentary to chapter X had been approved during the first part of the session. It would be amended in the light of the decisions just taken.

36. *The substance of the commentary to chapter X explaining the recommendations just adopted was approved.*

Chapter XII: Conflict of laws (A/CN.9/637 and Add.6)

Recommendations (recommendations 200-224) (A/CN.9/637)

37. **The Chairperson** noted that the recommendations pertaining to chapter XII had already been adopted during the first part of the session. However, some remaining issues needed to be addressed.

Recommendation 214

38. **Mr. Bazinas** (Secretariat) said that the Commission had requested the Secretariat to ensure that the draft Guide was consistent with the draft UNCITRAL convention on the carriage of goods. Following consultations with Working Group III (Transport Law), the Secretariat had decided to suggest deleting the reference in recommendation 214 (a) to the law applicable to the relationship “between the issuer of a negotiable document and the holder of a security right in the document” in order to avoid any inconsistency with the draft convention on the carriage of goods or other State transport legislation.

39. **The Chairperson** said that, if she heard no objection, she would take it that the Commission agreed to delete the phrase in recommendation 214 (a) referred to by the Secretariat.

40. *It was so decided.*

41. *Recommendation 214, as amended, was adopted.*

Recommendation 220

42. **Mr. Bazinas** (Secretariat) said that recommendation 220 had been moved from chapter XIV on the impact of insolvency on a security right in order to avoid inconsistencies with the UNCITRAL Legislative Guide on Insolvency Law (the UNCITRAL Insolvency Guide), which dealt with the law applicable to the validity and effectiveness of rights and claims but not with the law applicable to the general priority or the enforcement of a security right. The text of recommendation 220 had been amended slightly for purposes of clarity. The conflict-of-law rule that it contained was both generally acceptable and in line with the UNCITRAL Insolvency Guide, since the second sentence preserved the application of the *lex fori concursus*.

43. **The Chairperson** said that, if she heard no objection, she would take it that the Commission agreed to move recommendation 220 to chapter XII and to adopt the amended text.

44. *It was so decided.*

45. *Recommendation 220, as amended, was adopted.*

46. **Mr. Wezenbeek** (Observer for the European Commission) requested permission to make a proposal regarding recommendation 205 at the next meeting, following informal consultations with the members of the Commission.

47. **The Chairperson** said that the Commission had discussed recommendation 205 at great length during the earlier part of the session and she was reluctant to reopen the debate.

48. **Mr. Wezenbeek** (Observer for the European Commission) said that he had expressed reservations regarding the conflict-of-law chapter earlier in the session because there had been equally lengthy and difficult discussions within the European Union regarding the rule contained in recommendation 205. It was one of the core elements of the proposed regulation on the law applicable to contractual arrangements (Rome I), which would be applicable

to all States members of the European Union. A proposal made by the European Commission in 2005 that reflected the UNCITRAL rule had failed to secure the necessary support. The European Commission was now required to report to the European Council and the European Parliament on what it considered to be the best rule. It could either recommend the rule contained in the United Nations Assignment Convention or another rule, the law of the underlying claim, which was not even mentioned in the commentary to chapter XII but which was strongly supported by the securitization industry. As he felt that it was not just a European issue but had broader international importance, he wished to engage in informal consultations with the members of the Commission before suggesting any amendment.

49. **The Chairperson** said that it would be unfair to the members of the Commission, who had spent a great deal of time discussing the content of recommendation 205, not just at the current session but also during the previous session, to reopen the debate. However, she invited interested parties to engage in informal consultations during the suspension of the meeting with a view to finding a way to address the European Commission's concerns without reopening the discussion.

The meeting was suspended at 10.40 a.m. and resumed at 11.15 a.m.

50. **The Chairperson** suggested that the Commission should deal with the remaining chapters of the draft Guide and other outstanding issues before returning to the issue raised by the observer for the European Commission.

51. *It was so decided.*

Commentary to chapter XII: Conflict of laws (A/CN.9/637/Add.6)

52. **The Chairperson** noted that the substance of the commentary to chapter XII had been approved during the first part of the session. It would be amended in the light of the decisions just taken.

53. *The substance of the commentary to chapter XII explaining the recommendations just adopted was approved.*

Chapter XIII: Transition (A/CN.9/637 and Add.7)

Recommendations (recommendations 225-231)
(A/CN.9/637)

54. **The Chairperson** noted that the recommendations pertaining to chapter XIII had already been adopted during the first part of the session. However, two issues still needed to be addressed.

Recommendation 226

55. **Mr. Bazinas** (Secretariat) drew attention to the note following recommendation 226. The second sentence of the recommendation stated that if enforcement of a security right had commenced before the effective date of a new law, enforcement could continue under the law in force prior to the effective date. If the Commission considered that initiation of a post-default remedy before the effective date of the new law should result in the application of the prior law to the entire process of enforcement, it might wish to replace the word “may” in the second sentence by a stronger term should as “should” or “must”.

56. **Mr. Umarji** (India) said that any new law enacted pursuant to the draft Guide would be a procedural law that would not change the substantive character of the process of creation of security interests or the rights of secured creditors. Enacting States should be allowed a measure of flexibility in deciding whether the new law could be applied to pending cases or whether they would continue to be governed by the old law. He was therefore in favour of retaining “may” in the second sentence.

57. **Mr. Macdonald** (Canada) said that, in his view, the second sentence addressed the issue of the status of the enforcing creditor rather than the policy that the legislature should adopt. The question raised by the Secretariat was whether the Commission considered that, once a person had initiated enforcement proceedings under the prior law, it would be deprived of the option of abandoning the proceedings and initiating a fresh action under the new law. That approach would seriously undermine the normal principles of civil procedure. He was therefore in favour of maintaining the text as currently drafted, because it properly left the decision as to whether to continue the proceedings or to abandon them with the enforcing creditor.

58. **Mr. Sigman** (United States of America) proposed dealing with the situations described by the representatives of both India and Canada in the commentary so that legislators would understand that the purpose of the recommendation was to enhance flexibility.

59. **The Chairperson** said she took it that the Commission wished to leave recommendation 226 unchanged but to explain in the commentary that a secured creditor that had initiated enforcement proceedings under the law in force before the effective date of the new law should have the option of continued those proceedings under the old law or abandoning them and initiating proceedings under the new law.

60. *It was so decided.*

Recommendation 231

61. **Mr. Bazinas** (Secretariat) said that the purpose of recommendation 231 was to explain what recommendation 230 meant by a change in the status of a security right. The question raised in the note following recommendation 231 was whether recommendation 231 might be deleted if it was already clear that recommendation 230 was referring to the priority status of a security right. The substance of recommendation 231 could then be dealt with in the commentary.

62. **Mr. Cohen** (United States of America), supported by **Mr. Umarji** (India), proposed retaining recommendation 231, since recommendation 230 would be more difficult to understand if it were deleted. However, the word “priority” should be inserted before “status” in the chapeau of recommendation 231.

63. *Recommendation 231, as amended, was adopted.*

Commentary to chapter XIII: Transition
(A/CN.9/637/Add.7)

64. **The Chairperson** noted that the substance of the commentary to chapter XIII had been approved during the first part of the session. It would be amended in the light of the decisions just taken.

65. *The substance of the commentary to chapter XIII explaining the recommendations just adopted was approved.*

Chapter XIV: The impact of insolvency on a security right (A/CN.9/637 and Add.8)

Recommendations (recommendations 232-239) (A/CN.9/637)

66. **The Chairperson** noted that the recommendations pertaining to chapter XIV had already been adopted during the first part of the session. Some had been taken from the UNCITRAL Insolvency Guide.

67. **Ms. McCreath** (United Kingdom) pointed out that the definition of a “financial contract” taken from the UNCITRAL Insolvency Guide was inconsistent with the definition agreed on in paragraph 6 (s) of the “Terminology” section of the draft Guide.

68. **The Chairperson** said that both definitions, which should be viewed as forming part of a glossary rather than as strict legal definitions, were based on the United Nations Assignment Convention.

69. **Mr. Bazinas** (Secretariat) drew attention to a footnote to the definition in paragraph 6 (s), which referred the reader to article 5, subparagraph (k), of the United Nations Assignment Convention and to the relevant definition in the UNCITRAL Insolvency Guide. The paragraph following the definition explained that the reference to “any other transaction similar to any transaction referred to above entered into in financial markets” was intended to include the full range of transactions entered into in financial markets. A note to the Commission following the definition in the chapter on insolvency also referred the reader to article 5, subparagraph (k), of the Assignment Convention.

70. **Mr. Smith** (United States of America) said that the purpose of the reference to “any other transaction similar to any transaction referred to above” was to ensure flexibility, in other words to take account of future categories of transactions that should fall under the definition of financial contracts.

71. **Ms. McCreath** (United Kingdom) proposed reproducing the explanatory paragraph in the “Terminology” section in the insolvency chapter.

72. **The Chairperson** pointed out that the definitions in the insolvency chapter were extracts from the UNCITRAL Insolvency Guide. She suggested including an explanation instead in the commentary.

73. *It was so decided.*

Commentary to chapter XIV: The impact of insolvency on a security right (A/CN.9/637/Add.8)

74. **The Chairperson** noted that the substance of the commentary to chapter XIII had been approved during the first part of the session. It would be amended in the light of the decision just taken.

75. *The substance of the commentary to chapter XIV was approved.*

Proposals by the delegation of the United States of America (A/CN.9/637 and A/CN.9/XL/CRP.10)

76. **The Chairperson** invited the delegation of the United States to explain the intent of the proposals contained in document A/CN.9/XL/CRP.10.

77. **Mr. Sigman** (United States of America) said that the proposals, which covered the “Terminology” section and recommendations contained in document A/CN.9/637, were for the most part drafting proposals or suggested clarifications that would not affect any policy decisions already taken. Moreover, some of the proposals had already been addressed in the discussion and others had been withdrawn.

Terminology (A/CN.9/637 and A/CN.9/XL/CRP.10)

Proposed amendment to the definition of the term “control” with respect to a right to payment of funds credited to a bank

78. **Mr. Sigman** (United States of America) proposed clarifying the definition of “control” with respect to a right to payment of funds credited to a bank in subparagraph (n) (ii). As currently worded, it referred to a “control agreement” although that term had not been defined in the draft Guide. He therefore proposed deleting the portion of the

subparagraph that began with the word “evidenced” and inserting instead the following definition:

“‘Control agreement’ means an agreement between the depositary bank, the grantor and the secured creditor, evidenced by a signed writing, according to which the depositary bank has agreed to follow instructions from the secured creditor with respect to the payment of funds credited to the bank account without further consent from the grantor.”

79. **Mr. Schöfisch** (Germany) said that he had no objection to the proposal. He pointed out, however, that it constituted a new definition rather than a clarification.

80. **Mr. Deschamps** (Canada) asked whether the proposed definition of the term “control agreement” was used elsewhere in the draft Guide.

81. **Mr. Sigman** (United States of America) said that he was unsure whether the term was used elsewhere. He pointed out, however, that the wording of the proposed definition reproduced that already contained in subparagraph (n) (ii). If the word “agreement” was deleted, he would have no objection to retaining the original wording.

82. **The Chairperson** noted that the term “control agreement” was used in recommendations 100 and 123.

83. **Mr. Deschamps** (Canada) said that in that case he would support the proposal by the delegation of the United States.

84. *The proposed amendment was adopted.*

Proposed amendment to the definition of an “issuer”

85. **Mr. Sigman** (United States of America) proposed amending the phrase “whether that person performs all obligations or not” at the end of the definition of an “issuer” to read “whether or not that person has agreed to perform all obligations”.

86. **Mr. Pendón Maléndez** (Spain) expressed support for the proposal.

87. **Mr. Deschamps** (Canada) said that the words “all obligations” were somewhat vague. He proposed adding the words “arising from the document” to make it clear which obligations were being referred to.

88. **The Chairperson** said that, if she heard no objection, she would take it that the Commission agreed to the proposal by the United States delegation, as amended by the representative of Canada.

89. *The proposed amendment was adopted.*

Proposed insertion of a new definition

90. **The Chairperson**, referring to the proposal to add a new definition of a “registrable asset”, said that the Secretariat had informed her that no such term was used in the draft Guide.

91. **Mr. Sigman** (United States of America) said that his delegation proposed introducing the term because there were provisions in virtually every chapter dealing with specialized assets that were not defined. The references to such assets were sometimes incomplete or inconsistent. For instance, recommendation 38 referred to “a security right in movable assets that is subject to registration” and recommendation 202 contained the phrase “if a tangible asset is subject to registration”. In all cases, such phrases added to the length of the provisions and made them less intelligible. If a single defined term was used, all references would be identical, consistent and complete. The term proposed by his delegation denoted an asset the ownership of which was registered in a specialized registry and with respect to which a security right might also be registered.

92. **The Chairperson** said that term used in the draft Guide was “assets subject to registration in a specialized registry”.

93. **Mr. Schöfisch** (Germany) said that he had no objection to the inclusion of the new definition provided that it did not entail any change in the substance.

94. **Mr. Umarji** (India) and **Mr. Voulgaris** (Greece) said that if the new definition was not used in the text of the draft Guide, they saw no reason to include it.

95. **The Chairperson** said she understood that the object was to replace certain language in the draft Guide by the new term, which might indeed amount to a substantive change.

96. **Mr. Riffard** (France) said that while he could sympathize with the aim of making the language of the draft Guide more concise, he was unsure that it was wise to use the term “registrable asset”, since it might be misinterpreted.

97. **The Chairperson** noted that there was insufficient support for the inclusion of the new definition.

Proposed amendment to the definition of a “Right to receive the proceeds under an independent undertaking”

98. **Mr. Sigman** (United States of America) noted that the first paragraph of the definition stated that the term “right to receive the proceeds under an independent undertaking” did not include what was received upon honour of an independent undertaking. He proposed repeating “what is received upon honour” in the explanatory second sentence of the second paragraph in order to avoid giving the impression that a different standard was being proposed.

99. **Mr. Deschamps** (Canada) expressed support for the proposal.

100. *The proposed amendment was adopted.*

Alphabetical symbols preceding the definition of terms

101. **Ms. Stanivuković** (Serbia) proposed deleting the alphabetical symbols preceding the definitions in the “Terminology” section because the definitions themselves were set out in alphabetical order.

102. **The Chairperson** suggested requesting the Secretariat to consider deleting the symbols provided that such a step would not be inconsistent with United Nations editorial rules.

103. *It was so decided.*

Recommendations (A/CN.9/637 and A/CN.9/XL/CRP.10)

Proposed amendment to recommendation 5

104. **Mr. Sigman** (United States of America) said that recommendation 5 was designed to provide reassurance that the law recommended by the draft Guide did not apply to immovable property, except

as provided in recommendations 25 and 48 relating to the creation of a security right. However, other recommendations also had a bearing on immovable property, namely those concerning attachments to such property. The purpose of the proposed amendment was to state more accurately the full list of exceptions to the exclusion of immovable property from the scope of the draft Guide.

105. **Mr. Riffard** (France) expressed support for the amendment provided that it related solely to attachments to immovable property.

106. **Mr. Macdonald** (Canada) noted that the purpose of the proposed amendment was to ensure consistency. It should be quite clear from the wording, however, that a movable asset did not itself become immovable when it was attached to an immovable asset.

107. **The Chairperson** invited the Commission to reflect on the proposed amendment before its next meeting.

The meeting rose at 12.30 p.m.

Summary record of the 860th meeting, held at the Vienna International Centre
on Wednesday, 12 December 2007, at 2 p.m.

[A/CN.9/SR.860]

Chairperson: Ms. Sabo (Canada)

The meeting was called to order at 2.05 p.m.

Adoption of a draft UNCITRAL Legislative Guide on Secured Transactions and possible future work (A/CN.9/617, 620, 631 and Add. 1-11, and 637 and Add.1-8; A/CN.9/XL/CRP.10 and 11 and Add.1) (continued)

Recommendations (A/CN.9/637 and A/CN.9/XL/CRP.10) (continued)

Proposed amendment to recommendation 5 (continued)

1. **The Chairperson** invited the Commission to resume its consideration of the amendment to recommendations proposed by the delegation of the United States in document A/CN.9/XL/CRP.10.

2. **Mr. Bazinas** (Secretariat) asked whether it might be sufficient for the commentary to state that in cases where tangible assets that became attached to immovable property were treated as immovable property, recommendation 5 should be understood as excluding such assets. The clarification would be unnecessary in a legal system where a tangible asset remained movable property to the extent that it could be easily separated from the immovable property.

3. **Mr. Sigman** (United States of America) said that while he would welcome such an addition to the commentary, it failed to address all the points that arose. For instance, some recommendations discussed the remedies after default available to a person with a security right in an asset that became an attachment to immovable property. Such provisions clearly affected persons with an interest in immovable property.

4. **Mr. Macdonald** (Canada) expressed support for the proposed amendment because some recommendations could have a collateral effect on rights in immovable property. He proposed searching the draft Guide for all occurrences

of the word “immovable” and listing those recommendations.

5. **The Chairperson** said she took it that the Commission wished to amend the recommendation so that the first sentence merely stated that the law should not apply to immovable property, and the second sentence listed all recommendations that might affect rights in immovable property.

6. *It was so decided.*

Proposed amendments to recommendation 40

7. **Mr. Sigman** (United States of America) said that the purpose of the proposed amendments was to bring the structure of recommendation 40 into line with that of recommendation 45 which dealt with similar circumstances. In both cases a security right was effective against third parties for a fixed period of time and continued to be effective thereafter if a certain condition was met. In addition, the proposed new version of the recommendation was prefaced by the phrase “The law should provide that” and the word “or” before “do not consist of” was replaced by “and”, which was more logical.

8. **Mr. Deschamps** (Canada) expressed support for the proposed amendments.

9. *The proposed amendments to recommendation 40 were adopted.*

Proposed amendments to recommendation 54 (h)

10. **Mr. Sigman** (United States of America) noted that the provision stating the required content of a notice in the registry (recommendation 57 (a)) referred to the “identifier” rather than to the “name” of the grantor. He therefore proposed replacing the word “name” with “identifier” in recommendation 54 (h). Secondly, he proposed amending “or according to some other reliable identifier of the grantor” to read “and according to any other reliable identifying information specified

in the law". There were many countries where millions of people had the same given name and family name. It would be reasonable in such cases to use the name as a basic identifier but to add, for instance, an identity or health insurance number.

11. **Ms. McCreath** (United Kingdom) proposed replacing "reliable identifying information specified in the law" with something along the lines of "reliable and legally enforceable identifying information".

12. **Mr. Deschamps** (Canada) expressed support for the proposal by the representative of the United States. However, he proposed inserting the words "that may be" after the word "information" to make it clear that the provision of such information was not mandatory.

13. **Mr. Sigman** (United States of America) said that the phrase "specified in the law" had been included because it could not be left to registrants to decide what kind of additional identifier was acceptable. The registry should establish a rule governing second identifiers in cases where, for instance, given and family names were deemed to be insufficient. It was not mandatory for a jurisdiction to do so, but where the registry established such a rule, both identifiers should be indexed and retrievable. He understood the intention of the proposal by the representative of Canada, which he thought had been covered by the word "any" before "other reliable identifying information".

14. **Mr. Umarji** (India) said that the use of the word "and" rather than "or" with respect to the other identifying information was misleading because it gave the impression that both the identifier and the other identifying information had to be checked in all circumstances.

15. **Mr. Sigman** (United States of America) said that in that case the use of the word "or" was acceptable.

16. **Mr. Bazinas** (Secretariat) drew attention to recommendation 57 (a), which stated that the identifier of the grantor satisfying the standards laid down in recommendations 58 to 60 was required in the notice; recommendation 58, which referred to the grantor's correct identifier; and recommendation 59, which stated that where the grantor was a natural person, the identifier of the grantor for the purposes

of effective registration was the grantor's name and that, where necessary, additional information, such as the birth date or identity card number, should be required to uniquely identify the grantor. The term "identifier" thus already included the name and additional information. He also asked the representative of the United States whether the law referred to in the phrase "specified in the law" was secured transactions law or some other branch of law.

17. **Mr. Sigman** (United States of America) proposed ensuring that the wording of recommendation 54 (h) and recommendations 57 to 59 was consistent.

18. **The Chairperson** suggested requesting the Secretariat to review the wording of the recommendations mentioned by the representative of the United States to ensure that the use of the word "identifier" was consistent.

19. *It was so decided.*

Proposed amendments to recommendation 61

20. **Mr. Sigman** (United States of America) said that the first sentence of recommendation 61 referred to a change in "the identifier of the grantor used in the notice", whereas what had changed was the grantor's identifier as such. His delegation therefore proposed amending the first part of the sentence to read:

"The law should provide that, if, after a notice is registered, the identifier of the grantor changes and as a result the grantor's identifier provided in the notice does not meet the standard ...".

21. **Mr. Deschamps** (Canada) expressed support for the proposal.

22. *The first proposed amendment to recommendation 61 was adopted.*

23. **Mr. Sigman** (United States of America) proposed inserting the phrase "after the change in the grantor's identifier but" before the words "before registration of the amendment" in subparagraphs (a) and (b) of recommendation 61. He believed that the additional wording was consistent with the previous day's policy discussion regarding the need to protect innocent parties that

relied on the record. If it were omitted, a person that bought an encumbered asset from a grantor, taking it subject to a security right at the time when the grantor's original identifier was valid, would suddenly, if the grantor changed its identifier, take the asset free of the security right even though it had not been misled by the identifier on the public record. However, if the Commission considered that the proposal amounted to a substantive amendment, his delegation was willing to withdraw it.

24. **Ms. Walsh** (Canada) said that her delegation did not view the amendment as a substantive change but as a clarification. It therefore supported the proposal.

25. **Ms. Stanivuković** (Serbia) also expressed support for the proposal.

26. *The second proposed amendment to recommendation 61 was adopted.*

Proposed amendment to recommendation 64

27. **Mr. Sigman** (United States of America) said that his delegation proposed repeating the words "before and after" before "conclusion of the security agreement" in order to make the meaning crystal clear. The amended version would read: "The law should provide that a notice with respect to a security right may be registered before or after creation of the security right, or before or after conclusion of the security agreement."

28. **Mr. Deschamps** (Canada) expressed support for the proposal.

29. **Mr. Ginting** (Observer for Indonesia) asked how a security right could be registered before conclusion of the security agreement, since the agreement constituted the basis for the creation of the security right. He therefore proposed deleting the word "before or" in the phrase "before or after conclusion of the security agreement".

30. **Mr. Bazinas** (Secretariat) said that the Commission had considered cases in which the lender, following negotiations with the borrower, registered a notice prior to the conclusion of the security agreement. The notice did not create a security right but once the security agreement was concluded, it was backdated to the time of registration of the notice. If no security agreement

was concluded, the registration was without effect and the grantor could take steps to ensure its immediate deletion from the record.

31. **The Chairperson** said that, if she heard no objection, she would take it that the Commission wished to adopt the proposed amendment to recommendation 64.

32. *The proposed amendment to recommendation 64 was adopted.*

Proposed amendment to recommendation 66

33. **Mr. Sigman** (United States of America) proposing replacing the word "time" with "duration" in the following phrase in the third sentence: "If the law specifies the time of effectiveness of the registration".

34. **Mr. Deschamps** (Canada) expressed support for the proposal.

35. *The proposed amendment to recommendation 66 was adopted.*

Insertion of a new recommendation after recommendation 76

36. **Mr. Smith** (United States of America) said that his delegation had decided, in the light of informal consultations, to withdraw the proposal contained in document A/CN.9/XL/CRP.10 to insert a new recommendation after recommendation 76. However, it now proposed addressing the problem in the commentary.

37. The Commission had discussed the situation in which a grantor gave a security right to a secured creditor that was effective against third parties, but then sold the encumbered asset to a buyer that obtained the encumbered asset subject to the security right. Where that buyer also had a secured creditor which had made its security right effective against third parties with respect to the buyer, a priority conflict with respect to the encumbered asset would arise between the grantor's secured creditor and the buyer's secured creditor. The draft Guide's priority rule in recommendation 73 was designed to resolve such conflicts, but if both secured creditors had filed a notice, the priority dispute would be resolved under recommendation 73 in favour of the secured creditor that had filed

the notice first. That outcome made no sense in a situation where either the buyer's or the grantor's secured creditor might have filed first. The proposed new recommendation that his delegation had withdrawn had sought to resolve the conflict in favour of the grantor's secured creditor provided that the security right concerned remained effective against third parties. However, given the complexity of the issue, his delegation was now requesting that the commentary should make clear that recommendation 73 was intended to apply to priority disputes where the competing security rights were granted by the same grantor.

38. **Mr. Bazinas** (Secretariat) said that the issue had been discussed on a number of occasions. The commentary already explained that a priority conflict arose only where competing claimants had taken a security right from the same person. As the conflict just described by the representative of the United States was not a priority conflict under the draft Guide, it was unclear to him what should be inserted in the commentary. A reference might perhaps be made to general property law principles.

39. **Mr. Deschamps** (Canada) noted that "priority" was defined in the draft Guide as "the right of a person to derive the economic benefit of its security right in an encumbered asset in preference to a competing claimant". It was also clear that the definition of a competing claimant referred to competition between two or more persons that derived their interest from the same grantor. Moreover, the chapter on creation of a security right made it clear that a security right could not provide a secured creditor with more rights than the grantor enjoyed (*nemo dat quod non habet*). If those principles were to be made abundantly clear, the words "claimants holding" could be inserted in the first line of recommendation 73, which would then read: "The law should provide that priority between competing claimants holding security rights ...".

40. **Mr. Marca Paco** (Bolivia) said that his delegation was opposed to any amendment to recommendation 73.

41. **The Chairperson** suggested that the commentary should explain that recommendation 73 did not apply to priority conflicts between secured creditors that took a security right in an asset from different grantors. Accordingly, where a secured

creditor took a security right in an encumbered asset from a buyer of the asset, it took the asset subject to the security right granted in it by the seller, in accordance with the *nemo dat quod non habet* principle.

42. *It was so decided.*

Insertion of a new recommendation after recommendation 79

43. **Mr. Smith** (United States of America) said that his delegation was withdrawing its proposal contained in document A/CN.9/XL/CRP.10 to insert a new recommendation after recommendation 79 because it would amount to a substantive change. However, it now proposed that the issue should be addressed in the commentary.

44. If a grantor that had created a security right in an encumbered asset subsequently sold the asset, the sale was subject to the secured creditor's security right. However, if the secured creditor knew of the sale and took all steps necessary to ensure that the security right would continue, but nevertheless continued to lend money so that the total amount of secured obligations continued to increase even though all credit was now going to the grantor, some jurisdictions considered that there should be a cut-off point at which the transferee would take the asset free of the security right. Under the draft Guide, all future credit extended to the grantor under such circumstances continued to be secured by the encumbered asset.

45. **Mr. Deschamps** (Canada) proposed explaining in the commentary that States had two options. They could either apply the rule as it stood, so that the buyer would take the asset subject to a security right that would continue to guarantee all obligations, or they could opt for the alternative proposed by the representative of the United States.

46. **Mr. Smith** (United States of America) said he agreed that both options should be explained. However, the commentary should support the rule contained in the draft Guide.

47. **The Chairperson** said she took it that the Commission supported that approach.

48. *It was so decided.*

Proposed amendment to recommendation 108

49. **Mr. Smith** (United States of America) said that recommendation 108, as currently worded, required the secured creditor to preserve not only the encumbered asset itself but also its value. The secured creditor could easily preserve an asset such as a gold bar by making sure that it was not stolen, but it was unclear what action could be taken to preserve its value if the price of gold fell. As his delegation doubted whether it was the intention of the Commission to impose that kind of burden on the secured creditor, it proposed deleting the words “and its value” at the end of the recommendation. However, it was prepared to withdraw the proposed amendment if it had misinterpreted the rule.

50. **The Chairperson** said she feared that the amendment would amount to a substantive change.

51. **Mr. Kohn** (Observer for the Commercial Finance Association) said that there were many situations in which it was impossible for a secured creditor to preserve the value of an asset. His Association therefore considered that the amendment proposed by the United States was sensible in practical terms.

52. **Mr. Voulgaris** (Greece) said that he was opposed to the amendment because the party in possession of an encumbered asset was required only to take “reasonable steps” to preserve the value of the asset.

53. **Mr. Marca Paco** (Bolivia) also expressed a preference for retaining the text as it stood.

54. **Mr. Deschamps** (Canada) referred by way of example to the case of a promissory note pledged to a secured creditor. Under the laws of many jurisdictions, the note would have to be presented for payment on its maturity date in order to preserve the holder’s recourse against an endorser. Recommendation 108, as currently worded, seemed to require the pledgee of the promissory note to present it for payment on maturity. However, the secured creditor would have the option in many jurisdictions of protecting itself by negotiating a waiver in the security agreement. If the parties had not negotiated such a waiver, the default rule should perhaps be that set out in recommendation 108.

55. **Mr. Pendón Meléndez** (Spain) pointed out that the term “value” had many different shades of meaning, not just in economic terms or in terms of profitability, but also in legal and social terms. Those shades of meaning also had a bearing on the idea of “preservation”. He was therefore in favour of maintaining the recommendation as it stood.

56. **Mr. Porreca** (Italy) expressed the view that deletion of the reference to the asset’s value would defeat the purpose of recommendation 108.

57. **Mr. Schneider** (Germany) said that his delegation was strongly opposed to any amendment. If the encumbered asset was a car, for instance, and the grantor retained possession, it was clearly liable for payment of insurance, repairs and other similar costs.

58. **Mr. Sigman** (United States of America) said that his delegation withdrew its proposed amendment but proposed that the commentary should reflect the discussion, explaining that the rule applied only to security rights in tangible assets subject to possession.

59. **The Chairperson** said she took it that the Commission agreed that the commentary should include that explanation.

60. *It was so decided.*

The meeting was suspended at 3.45 p.m. and resumed at 4.05 p.m.

Proposed amendment to recommendation 109

61. **Mr. Sigman** (United States of America) noted that the question of what happened when a secured obligation was extinguished was addressed in recommendations 69, 109 and 137. Recommendation 69 dealt with cases in which the secured creditor was obliged to terminate its notice and spelt out the grantor’s correlative right in that regard. Recommendation 109 dealt with the physical return of an encumbered asset if it was in the possession of the secured creditor at the time of extinction of the obligation, and recommendation 137 dealt with enforcement provisions, indicating how to achieve extinction of the security right. Recommendations 69 and 109 both simply contained the phrase “extinguished by full payment or otherwise”. The third sentence of

recommendation 137, on the other hand, contained in addition the phrase “[i]f all commitments to extend credit have terminated”. His delegation was proposing a slight different amendment to that contained in document A/CN.9/XL/CRP.10, namely to insert the phrase “as provided in the last sentence of recommendation 137” after the word “extinguished” in recommendations 69 and 109.

62. **Mr. Umarji** (India) expressed support for the proposed amendment, which would be applicable, in particular, to banks’ practice of extending revolving credit.

63. **Mr. Riffard** (France) said that he had no objection to the substance of the proposed amendment. However, his delegation would prefer to amend recommendation 109 to read:

“The secured creditor must return an encumbered asset in its possession if, all commitments to extend credit having been terminated, the security right has been extinguished by full payment or otherwise.”

64. **Mr. Deschamps** (Canada) said that his delegation would be prepared to support either amendment.

65. **Mr. Sigman** (United States of America) indicated that the amendment proposed by the representative of France would be acceptable to his delegation, provided that recommendation 69 was also brought into conformity with recommendation 137.

66. **The Chairperson** said that, if she heard no objection, she would take it that the Commission agreed to adopt the amendment proposed by the representative of France and to leave it to the Secretariat to ensure that the three recommendations were consistent.

67. *It was so decided.*

Proposed amendment to recommendation 124 (b)

68. **Mr. Sigman** (United States of America) said that the purpose of the proposed amendment to recommendation 124 (b) was to make it clear that the phrase “acquired from or created by the transferor” referred to the security right and not to the rights of the transferee. His delegation therefore proposed deleting the words “acquired from”.

69. **Mr. Ginting** (Indonesia) expressed support for the proposed amendment. However, to prevent misunderstanding, he proposed restructuring the second half of the sentence to read: “... right to receive the proceeds created by the transferor or any prior transferor under the independent undertaking”.

70. **The Chairperson** pointed out that the draft Guide had defined “proceeds under an independent undertaking”, the phrase contained in the original version of the subparagraph, in its “Terminology” section. She took it that the Commission wished to adopt the amendment proposed by the delegation of the United States.

71. *The proposed amendment to recommendation 124 (b) was adopted.*

Proposed amendment to recommendation 156

72. **Mr. Sigman** (United States of America) said that his delegation was withdrawing its proposal in document A/CN.9/XL/CRP.10 to delete recommendation 156 but remained concerned about its implications. Recommendations 153 to 155 described the process whereby a secured creditor proposed to acquire encumbered assets in satisfaction of a secured obligation. Moreover, under recommendation 156, the grantor was given the option of proposing to the secured creditor that it exercise that remedy. If the secured creditor agreed, it was required to proceed in accordance with recommendations 154 and 155. It was unclear whether the grantor was also under an obligation not to object to the terms involved. He proposed that the commentary should spell out the consequences of the provision contained in recommendation 156.

73. **Mr. Bazinas** (Secretariat) said that the commentary had been prepared on the understanding that once the grantor had asked the secured creditor to make the proposal, the secured creditor would be required under recommendation 154 to give notice to all the parties listed in that recommendation, and that any addressee of the proposal would be entitled under recommendation 155 to object.

74. **Mr. Umarji** (India) said that the Secretariat’s understanding was, in his view, correct. The only outstanding question was whether the grantor,

having formally made the proposal, could subsequently withdraw it.

75. **Mr. Bazinas** (Secretariat) expressed the view that the grantor would be entitled to object to the terms of the secured creditor's proposal if they were unreasonable.

76. **Mr. Macdonald** (Canada) said that the question had been raised when recommendation 156 was adopted during the first part of the session. It was his understanding that the sole purpose of the provision was to allow the grantor to take the initiative. He expressed support for the proposal by the delegation of the United States to spell out its implications in the commentary.

77. **The Chairperson** said she took it that the Commission agreed to entrust the Secretariat with the task of clarifying the situation in the commentary.

78. *It was so decided.*

Proposed amendment to recommendation 165

79. **Mr. Sigman** (United States of America) said that the purpose of his delegation's proposed amendment to recommendation 165 was to ensure that the wording was consistent with the definition of "assignment" in the "Terminology" section, which first referred to the creation of a security right in a receivable by way of assignment and then stated that the term also included an outright transfer of a receivable for convenience of reference. Recommendation 165, as currently worded, mentioned in the first sentence "a receivable assigned by an outright transfer" and in the second sentence "a receivable assigned by way of security" without referring to a security right. His delegation proposed replacing the phrase in the second sentence with "a receivable assigned otherwise than by an outright transfer", although it might have been more appropriate, in light of the definition, to introduce a reference to a security right.

80. **The Chairperson** said that, if she heard no objection, she would take it that the Commission approved the amendment proposed by the delegation of the United States.

81. *The proposed amendment to recommendation 165 was adopted.*

Proposed amendment to recommendation 187

82. **Mr. Sigman** (United States of America) said that the purpose of his delegation's proposed amendment to recommendation 187 was to make it clear that a security right did not "encumber" an asset only to the extent of the asset's value. The beginning of the second sentence should be amended to read: "The maximum amount realizable from the security right is the asset's value...".

83. **The Chairperson** said that, if she heard no objection, she would take it that the Commission approved the amendment proposed by the delegation of the United States. She asked the Secretariat to search the draft Guide for any other references to a security right "encumbering" an asset and to make the requisite amendments in order to ensure consistency.

84. *The proposed amendment to recommendation 187 was adopted.*

Proposed amendment to recommendation 188

85. **Mr. Sigman** (United States of America) drew attention to a difference between the wording of recommendation 186, which used the phrase "is concluded in or evidenced by a writing", and that of recommendation 188, which merely stated "is evidenced in accordance with recommendation 186". His delegation proposed to reproduce the wording of recommendation 186 in recommendation 188.

86. **Mr. Macdonald** (Canada) noted that the wording of recommendation 15 was the same as that used in recommendation 186.

87. **The Chairperson** pointed out that both recommendation 15 and recommendation 186 were referring to an agreement, whereas recommendation 188 was referring to a right.

88. **Mr. Sigman** (United States of America) withdrew his delegation's proposal.

Proposed amendment to recommendation 204

89. **Mr. Sigman** (United States of America) said that the purpose of his delegation's proposed restructuring of recommendation 204 was simply to make it clear, by bringing forward the phrase "provided that the asset reaches the State of its

ultimate destination within [...] days after the time of creation of the security right”, that that proviso referred only to the alternative place of registration.

90. **Mr. Deschamps** (Canada) expressed support for the proposed amendment.

91. **The Chairperson** said that, if she heard no objection, she would take it that the Commission approved the amendment proposed by the delegation of the United States.

92. *The proposed amendment to recommendation 204 was adopted.*

93. **The Chairperson** noted that the Commission had thus concluded its consideration of document A/CN.9/XL/CRP.10 containing proposed amendments by the delegation of the United States.

94. **Mr. Riffard** (France) proposed giving a mandate to the Secretariat to review the entire draft Guide with a view to removing any redundant material and making it as concise and reader-friendly as possible.

95. **Mr. Macdonald** (Canada) expressed support for the proposal, noting that repetition occurred mostly in introductory paragraphs and did not affect substantive points.

96. **Mr. Schöfisch** (Germany) expressed the view that it might be difficult for the Secretariat to be sure that its changes were strictly editorial and not substantive.

97. **The Chairperson** suggested that the Secretariat should err on the side of caution.

98. **Mr. Sekolec** (Secretary of the Commission) reassured the Commission that the guidance it had received was sufficient to enable it to carry out its review assignment with full confidence.

Recommendation 205: Proposal by the observer for the European Commission

99. **The Chairperson** invited the observer for the European Commission to introduce his proposal regarding recommendation 205. She urged him to bear in mind, however, that most of the participants were not members of the European Union.

100. **Mr. Wezenbeek** (Observer for the European Commission) said that the European Union had a problem with chapter XII of the draft Guide concerning conflict of laws, particularly in the context of its proposed regulation on the law applicable to contractual arrangements (Rome I). In his view, it was not a purely European issue but had potential implications for global industry. The European Commission was not proposing to amend recommendation 205, since it had already been adopted. However, it would circulate text referring to different options that were available and used by industry. For instance, the law of the underlying claim was not mentioned in the commentary to chapter XII, although it was already being successfully applied, particularly by the securitization industry. It would be unfortunate, also for developing countries, if the draft Guide remained silent on such developments.

101. **Mr. Burman** (United States of America) said that informal consultations had begun on the text mentioned by the observer for the European Commission. While his delegation would be very reluctant to add text to recommendation 205, it would not be averse to including appropriate references to the issues raised in the commentary to chapter XII.

The meeting rose at 5 p.m.

Summary record of the 861st meeting, held at the Vienna International Centre
on Thursday, 13 December 2007, at 9.30 a.m.

[A/CN.9/SR.861]

Chairperson: Ms. Sabo (Canada)

The meeting was called to order at 9.40 a.m.

Adoption of a draft UNCITRAL Legislative Guide on Secured Transactions and possible future work (A/CN.9/617, 620, 631 and Add. 1-11, and 637 and Add.1-8; A/CN.9/XL/CRP.10 and 11 and Add.1)
(continued)

Recommendation 205: Proposal by the observer for the European Commission (continued)

1. **The Chairperson** invited the Commission to resume its consideration of the proposal made by the observer for the European Commission.

2. **Ms. Perkins** (United Kingdom) said that her delegation had grave concerns about the current wording of recommendation 205 because it went a great deal further than the European Union's proposed regulation on the law applicable to contractual arrangements (Rome I). Recommendation 205 provided that the law applicable to the creation of a security right was the law of the State in which the grantor was located. In her view, that matter had been settled under European Community law in the 1980 Rome Convention on the law applicable to contractual obligations.

3. Her delegation had consistently voiced its concern about the recommendation's implications for financial contracts that had not been excluded from the scope of the draft Guide, financial contracts that were not governed by netting agreements, spot trading and some forward trading of commodities, and the assignment of positions under such trading. Moreover, some over-the-counter equity derivatives and bond options might not be backed up by netting agreements, for instance because they were old agreements, because there had been an oversight or due to pressures of fast trading. There was also no indication that receivables arising from insurance contracts had been excluded from the scope of the draft Guide. As

the beneficiaries of insurance policies might be natural persons, ships or mobile businesses, it was extremely common for the grantor's location to change frequently. Recommendation 205 was not an appropriate conflict-of-law rule either for securitization transactions, residential or commercial mortgage-backed securities, collateralized debt obligations (CDOs), collateralized bond obligations (CBOs) and collateralized loan obligations (CLOs).

4. While her delegation appreciated the important role of recommendation 205 with respect to certain financial practices, it had a number of proposals for additional wording that would create a measure of flexibility for jurisdictions that wished to apply a different conflict-of-law rule to the key markets and industries that she had mentioned. One option discussed in informal consultations with other delegations was to provide for two alternatives, A and B, so that States could either apply recommendation 205 as currently worded or apply it as the basic rule with a carve-out for cases where the underlying intangible asset was created by a contract. If that solution was considered to be too radical, her delegation was prepared to propose instead that the word "ordinarily" should be inserted in the opening phrase of recommendation 205, which would then read: "The law should ordinarily provide that ...". The commentary would then explain that some key financial markets and medium-level financing practices were not adequately served by the rule laid down in recommendation 205.

5. **Ms. Gibbons** (United Kingdom) said that she was both an adviser to the British Government and a partner in a law firm with responsibility, inter alia, for framing legal opinions regarding securitization transactions.

6. Noting that certainty was one of the key objectives of the draft Guide, she said that if a rule such as that in recommendation 205 were to be

applied without any provision for derogation, it would undermine certainty in the securitization market. A key feature of securitization transactions, which were now an international phenomenon and by no means confined to the London-based market, was that rating agencies required a measure of certainty, which was achieved through an assessment of the commercial risks involved in the transaction and through legal opinions.

7. For example, an originator whose “centre of main interest” under the European Community Regulation on Insolvency Proceedings was in France might also enter into contracts with grantors in Germany and Spain. The benefit of those contracts might be assigned by the originating company in the form of an outright transfer to a special purpose vehicle, which in turn might assign its interest in the contracts to a security trustee. Both assignments would be covered by the terms of the draft Guide. Under current practice, the assignments would be governed by the law of the underlying contract, in other words by French law. Under recommendation 205, however, it would be necessary to determine the current location of the grantor, which was not always clear. Many businesses had branches in a large number of different countries and a grantor’s place of residence could change. Each time an originator made further issuances, new legal opinions would become necessary to establish its location and it would be extremely difficult to present rating agencies with a reliable assessment of the legal risks involved.

8. **Mr. Deschamps** (Canada) noted that securitization had frequently been cited some years previously as a branch that benefited from the assignor location rule under the United Nations Convention on the Assignment of Receivables in International Trade (United Nations Assignment Convention). His company had recently been consulted by an international law firm about a securitization transaction involving an originator with its centre of main interest in France and with customers in some ten other countries, including Canada. The firm’s lawyer had commented that it was unfortunate that France did not apply the same conflict-of-law rule as Canada, namely the assignor location rule.

9. **Mr. Umarji** (India) said that in the event of default and enforcement of a loan, the grantor could not be required to move from one jurisdiction to another in response to actions for recovery. The grantor’s interests should also be protected. He was therefore opposed to any amendment of recommendation 205.

10. **Mr. Smith** (United States of America) expressed support for the views expressed by the previous two speakers. Securitization transactions were commonly undertaken in jurisdictions that applied the conflict-of-law rule set out in recommendation 205 without entailing any systemic risk or trouble with rating agencies. No rule was perfect, but the Commission had concluded after lengthy deliberations that, on balance, the rule contained in recommendation 205 was the best available. It would work, for example, in situations where financing was sought against a pool of receivables involving contracts that were governed by the laws of a number of different countries. He was aware that the “centre of main interest” criterion had given rise to litigation in Europe, but the problems addressed in the cases concerned were relatively unusual. In most transactions it was quite clear where the grantor was located and the financing documents would normally restrict the grantor’s freedom to change location. He strongly supported recommendation 205 because it ensured certainty and low transaction cost, furthered the purposes of the draft Guide and was consistent with the United Nations Assignment Convention.

11. **Mr. Schöfisch** (Germany) said that the purpose of the draft Guide was to give advice to States and to provide them with information. Unfortunately, recommendation 205 omitted relevant information by failing to mention that some States had opted for different approaches, which could be explained in the commentary. The concerns described by the delegation of the United Kingdom underscored the usefulness of such a clarification, which should be couched in neutral terms in the text of the recommendation.

12. **Mr. Kalns** (Latvia) expressed support for the proposal by the representative of Germany.

13. **The Chairperson** pointed out that the purpose of the recommendation was to present the Commission’s decision regarding what it considered

to be the best solution and that of the commentary was to present the different options. Working Group VI (Security Interests) and the Commission had discussed the issues raised by the delegation of the United Kingdom at length and had taken a decision in full knowledge of the implications of the rule in recommendation 205. As already noted, the matter had also been discussed in the context of the negotiations on the United Nations Assignment Convention. The Commission could not now reverse its decisions in those two cases.

14. **Mr. Porreca** (Italy) expressed support for the comments and proposals made by the delegation of the United Kingdom. Although the Commission had already adopted a decision, he saw no reason why it should not show some flexibility in such a complex matter in order to accommodate all concerns. Its main aim should be to promote the widest possible utilization of the draft Guide by legislators.

15. **Mr. Kohn** (Observer for the Commercial Finance Association) said that one of the goals of the draft Guide was to minimize transaction costs, which could make financing prohibitively expensive. As such costs were particularly high in the case of securitization transactions, the rule in recommendation 205 would make it easier for many companies to obtain access to secured credit. He submitted that in the vast majority of situations, it was easy to determine the location of the grantor. On the other hand, where the pool of receivables involved customers in many jurisdictions, the process of determining the applicable law could be time-consuming. In many cases, there was no express choice of law in the documents generating the receivable, and considerable due diligence was required to determine which law was applicable and what the law stipulated regarding the creation, effectiveness and priority of a security right.

16. **Mr. Markus** (Switzerland) said that he agreed with the Chairperson that it would be inappropriate to change the Commission's decision regarding recommendation 205. On the other hand, as serious concerns had been raised, he proposed showing some flexibility in the commentary by outlining options that could be viewed as the second best approach. Moreover, to promote legal certainty regarding possible changes in the location of the grantor, he proposed referring in the commentary to

the possibility of establishing a point in time that would be decisive for the purpose of determining the grantor's location.

17. **Mr. Voulgaris** (Greece) and **Mr. Riffard** (France) expressed support for the proposal by the representative of Switzerland.

18. **Ms. Kaller** (Austria), **Ms. Kolibabska** (Poland), **Ms. Gavrilesco** (Observer for Romania) and **Mr. Urminský** (Observer for Slovakia) expressed support for the position stated by the delegation of the United Kingdom and also for previous speakers who had called for flexibility so that as many jurisdictions as possible could apply the draft Guide.

19. **Mr. Bazinas** (Secretariat) said that the commentary, as it stood, sought to reflect the different approaches adopted in different jurisdictions and could be expanded if the Commission so desired.

20. He pointed out that conventions prepared by UNCITRAL were draft conventions that were submitted for adoption by diplomatic conferences or the General Assembly. Once an instrument had been adopted by either of those bodies, it could be amended only in accordance with the rule laid down in the text. Under the United Nations Assignment Convention, one third of the Contracting States could request the holding of a diplomatic conference to revise or amend the Convention. The Commission, as a subsidiary body of the General Assembly, could not circumvent the amendment or revision process by introducing a change of policy through a model law, guide or recommendation.

21. According to practitioners in many parts of the world, the advantages of the rule laid down in recommendation 205 were mainly felt in the context of receivables financing. Where there was a bulk assignment of receivables, a key concern was the insolvency of the assignor. That consideration had strongly influenced the decision by the Commission and the General Assembly to recommend that the applicable law should be the law of the most likely location of the main insolvency proceedings with respect to the assignor, grantor or borrower, thus ensuring that the same law would govern priority and the ranking of claims in insolvency proceedings.

22. **The Chairperson** said that it was important to try to resolve all concerns within the constraints under which the Commission was operating. However, she had been present during the negotiation of the United Nations Assignment Convention and at the drafting sessions of Working Group VI on the draft Guide and she had heard no new arguments at the present meeting on either side. Although certain financial practices had become more prominent in recent years, the fundamental reasoning that had led to the policy decisions remained unchanged. In that context, she invited the Commission to consider how the helpful proposal by the delegation of Switzerland might be reflected in the commentary.

23. **Mr. Wezenbeek** (Observer for the European Commission) said that the European Commission had been requested to undertake an impact assessment on the issue under discussion and to report its findings to the European Council in two years' time. The member States of the European Union had discussed chapter XII of the draft Guide and concluded that it should be placed on hold. However, he felt that such a request to the Commission would be inappropriate and would fail to do justice to the fine work it had accomplished to date. Nevertheless, sections of industry throughout the European Union were dissatisfied with the rule laid down in recommendation 205 and only one member State had signed the United Nations Assignment Convention. It would therefore be unfortunate if there was no possibility of considering a minor amendment to the recommendation, such as inserting the word "ordinarily", as proposed by the delegation of the United Kingdom, and then expanding the commentary to explain other practices.

24. **Ms. McCreath** (United Kingdom) said that her delegation did not view its proposal as a formal amendment but rather as a pointer to other practices. She noted that the draft Guide expanded on the definition of a financial contract in the United Nations Assignment Convention in order to clarify what normally occurred in financial markets.

25. **Ms. Gibbons** (United Kingdom) said that in the securitization industry it was necessary in all cases involving several grantors of significant size in different jurisdictions to examine the

enforceability of contracts in the grantors' local jurisdictions in order to inform rating agencies of the risks involved. The rule laid down in recommendation 205 did not detract from the need to be aware of the rules governing grantors by virtue of the contracts into which they had entered with the originator and the jurisdiction in which they were located. It simply introduced an additional jurisdiction to investigate. Moreover, it was not always easy to determine and deliver a legal opinion on where a company's centre of main interest was located. The due diligence involved might in fact prove quite costly.

26. **Ms. Perkins** (United Kingdom) said that the commentary failed to address her delegation's concerns regarding the applicable law, since it referred to the law of the grantor's residence and the *lex situs* of the intangible asset but not to the law in the contract that created the intangible asset, in other words the law of the receivable.

27. She wondered whether the creation of security rights in shipping insurance contracts had been discussed when the United Nations Assignment Convention was being negotiated. The common practice of repeatedly assigning an insurance policy relating to a ship and its contents had given rise to a substantial amount of case law on the subject in the United Kingdom. She had been informed by English judges that the rule contained in recommendation 205 was not applicable to such cases.

28. There was clearly no consensus in the Commission that one rule could be identified as the best for all States in every circumstance. While one rule was certainly the best for a wide range of financial situations, a different rule might be more appropriate for other kinds of secured transactions. She submitted that her delegation's proposal to add a single word to the recommendation and to explain different options in the commentary was not excessive.

29. **Mr. Deschamps** (Canada) said that his delegation agreed that the commentary should be more detailed and expand on the various alternatives, presenting the law governing the receivable as an alternative to the *lex situs*.

30. With regard to recommendation 205, the delegation of the United Kingdom had proposed excluding cases where the underlying intangible asset was created by a contract or, if that was too radical, inserting the word “ordinarily” in the opening phrase. If intangible assets arising from contracts were excluded, however, recommendation 205 might as well be omitted from the draft Guide because financial contracts, securities and other items were already excluded. He urged delegations that were in favour of replacing the grantor’s location rule by a rule based on the law governing the receivable to compare the advantages and disadvantages of the two rules not only with regard to an assignment of a specific receivable but also with regard to a bulk assignment, especially one including future receivables. If the priority of the assignee with respect to future receivables was unknown, as it might well be if a rule based on the law governing the receivable was adopted, it would be difficult to provide sound advice to a rating agency.

31. The word “ordinarily” was too vague to be included in the recommendation itself but it could be inserted in the commentary, which might state, for instance, that the general rule proposed in the recommendation would ordinarily be applicable to situations involving trade receivables.

32. **Mr. Umarji** (India) said that it was debatable whether the draft Guide covered marine insurance policies relating to ships and the receivables under such policies. In any case, assignments in that context would constitute a very limited area in terms of the scope of the draft Guide.

33. **Mr. Smith** (United States of America) expressed support for the comments by the representative of Canada. However, he had reservations about the use of the word “ordinarily” in the commentary because it would be undesirable, for instance, to apply one conflict-of-law rule to a loan and another to a related securitization transaction. A single conflict-of-law rule was essential in order to determine priority.

34. A rule based on the law governing the receivable would be inconsistent with the draft Guide’s aim of encouraging countries with emerging economies to improve their secured transactions law. Developed countries were enacting

sophisticated laws to accommodate securitization transactions and anyone entering into a commercial transaction would clearly wish to have it governed by such a law rather than by the law of a developing country.

35. **The Chairperson** said she took it that, in view of the strong objections that had been raised to any reopening of the debate on recommendation 205, the Commission agreed to address the concerns expressed by a number of its members in the commentary.

36. *It was so decided.*

37. **Ms. McCreath** (United Kingdom) requested that the official record of the session reflect her delegation’s position that recommendation 205 was not the best rule and its concern about the rule’s possible adverse impact on the industries mentioned in its earlier statements.

The meeting was suspended at 11.35 a.m. and resumed at 12.05 p.m.

38. **Mr. Smith** (United States of America) read out the following paragraph, which he described as a starting point for further elaboration of the commentary:

“Some countries have a different conflict-of-law rule for intangibles from the rule in recommendation 205. Those countries contemplate capital market or other transactions, which seek perhaps greater certainty established by looking not to the law of the grantor’s location, but rather to the law governing the intangible. The rule that looks to the law governing the intangible has the advantages of avoiding the risk of a subsequent change of location of the grantor and a single, stable conflict-of-law rule for transactions involving successive assignments of the intangibles among assignors located in different countries. It is not as advantageous for the assignment of intangibles in bulk that may be governed by the laws of multiple countries. Moreover, it shifts the risk of a change of location of the grantor to the risk of a change in the law governing the intangible.”

39. **Mr. Wezenbeek** (Observer for the European Commission) said that the representatives of

member States of the European Union attending the session very much regretted the decision not to reopen the debate on recommendation 205 notwithstanding the considerable support that had been expressed for the proposal by the delegation of the United Kingdom to insert the word “ordinarily” in the opening phrase of the recommendation. They requested that their position should be reflected in the record.

40. The preliminary response of the same delegations to the text proposed by the representative of the United States was that the last two sentences were not sufficiently factual and should be deleted.

41. **The Chairperson** pointed out that, in the view of a number of delegations of member States of the Commission, the insertion of the word “ordinarily” in the recommendation would have amounted to a substantive amendment to a text that had already been adopted by the Commission.

42. **Mr. Burman** (United States of America) suggested that the record should also reflect the fact that other delegations had withdrawn a number of proposed amendments regarding substantive matters that they considered to be important.

43. **Mr. Schöfisch** (Germany), welcoming the proposal to expand the commentary to reflect different options, expressed a preference for a neutral approach that would refrain from stating that one option was better than another.

44. **The Chairperson** said that the Commission had been careful in the draft Guide to ensure that the commentary covered all options but at the same time explained why a particular option was being recommended. On the other hand, where alternatives were offered, as in the recommendations regarding the unitary and non-unitary approaches, it had adopted a more neutral and balanced approach.

45. She took it that the Commission wished to give a mandate to the Secretariat to reflect the discussion that had taken place at the meeting as well as the content of the proposal by the delegation of the United States in the commentary.

46. *It was so decided.*

Revised commentary to chapter VII: Priority of a security right (A/CN.9/637/Add.1)

47. **The Chairperson**, noting that the Commission had approved the substance of the original commentary to chapter VII during the first part of the session, asked whether members had any comments on the revised version.

48. **Ms. Walsh** (Canada) proposed clarifying that the rules on priorities were designed to deal with competing rights of claimants all of which were derived from the same grantor.

49. She further proposed making a clearer distinction between third-party effectiveness issues and priority issues and, in general, avoiding repetition in the commentary.

50. *The substance of the revised commentary was approved subject to those amendments and any necessary editorial modifications.*

Revised commentaries to chapter VIII: Rights and obligations of the parties; chapter IX: Rights and obligations of third-party obligors; chapter X: Enforcement of a security right; and chapter XI: Acquisition financing (A/CN.9/637/Add.7-5)

51. **The Chairperson** noted that the Commission had approved the substance of the original versions of the commentaries to chapters VIII to XI during the first part of the session. It had also decided earlier in the resumed session to reflect the changes to the recommendations under chapter XI in the commentary.

52. *The substance of the revised commentaries was approved subject to any necessary editorial modifications.*

Revised commentary to chapter XII: Conflict of laws (A/CN.9/637/Add.6)

53. **The Chairperson** noted that the Commission had approved the substance of the original commentary to chapter XII at the first part of the session.

54. **Ms. Perkins** (United Kingdom) said that the revised commentary failed to explain the interrelationship between recommendations 45, 205 and 217. Uncertainty arose where an assignor changed location and different priority rules were

applicable under the laws of the first and second location. Under recommendation 217, the law of the new location would govern third-party effectiveness and priority, but that rule would leave the first assignee unduly exposed. Under recommendation 45, however, the assignee was given a brief period during which it could close its exposure window by making its security right effective against parties under the law of the assignor's new location. The procedure for remedying uncertainty was thus somewhat tortuous. Moreover, recommendation 45 might not be applicable in the forum State.

55. **The Chairperson** said she took it that the commentary should explain the interaction between recommendations 45, 205 and 217, in particular with a view to explaining how the problem of a change in the grantor's location was addressed under the draft Guide.

56. *The substance of the revised commentary was approved subject to that decision and any necessary editorial modifications.*

The meeting rose at 12.35 p.m.

**Summary record of the 862nd meeting, held at the Vienna International Centre
on Thursday, 13 December 2007, at 2 p.m.**

[A/CN.9/SR.862]

Chairperson: Ms. Sabo (Canada)

The meeting was called to order at 2.05 p.m.

**Adoption of a draft UNCITRAL Legislative Guide
on Secured Transactions and possible future work**

(A/CN.9/617, 620, 631 and Add. 1-11, and 637 and
Add.1-8; A/CN.9/XL/CRP.10 and 11 and Add.1)

(continued)

*Revised commentaries to chapter XIII: Transition;
and chapter XIV: Insolvency (A/CN.9/637/Add.7
and 8)*

1. **The Chairperson** noted that the Commission had approved the substance of the original versions of the commentaries to chapters XIII to XIV during the first part of the session. It had also decided earlier in the resumed session to reflect the changes to the recommendations under the chapter XIII in the commentary.

2. *The substance of the revised commentaries was approved subject to any necessary editorial modifications.*

3. **The Chairperson** said that the discussion of the draft Guide had thus been concluded. She recalled that when the project of a legislative guide on secured transactions had first been proposed, the idea had been received with a certain amount of scepticism. The Commission had nevertheless produced what would certainly be recognized as a valuable tool for legislators. Although there had been heated discussions on many points, she urged members to rise above those points and focus instead on the draft Guide as a whole, which was a tremendous accomplishment. She warmly thanked all those who had contributed to the process, including, in particular, the Secretariat.

4. **Mr. Schneider** (Germany) expressed warm thanks on behalf of the Commission to the Chairperson and the Secretariat.

The discussion covered in the summary record ended at 2.15 p.m.

**Summary record (partial) of the 863rd meeting, held at the Vienna International Centre
on Friday, 14 December 2007, at 9.30 a.m.**

[A/CN.9/SR.863]

Chairperson: Ms. Sabo (Canada)

The meeting was called to order at 9.45 a.m.

The discussion covered in the summary record began at 11.35 a.m.

Adoption of the report of the Commission
(continued)

1. **The Chairperson** invited the Rapporteur, Mr. Umarji (India), to introduce the draft report of the Commission on the work of its resumed session.

2. **Mr. Umarji** (India), Rapporteur, said that it had been a difficult task to produce a legislative guide that could be applied by the world's many different legal systems. He was confident that the enactment of laws based on the recommendations in the draft Guide in the years ahead would make an important contribution to the harmonization of international trade practices.

Adoption of a draft UNCITRAL Legislative Guide on Secured Transactions (A/CN.9/XL/CRP.9/Add.1-4)
(continued)

Draft report on chapters IV to VI
(A/CN.9/XL/CRP.9/Add.1 and Add.2)

1. Chapter IV: Creation of a security right (effectiveness as between the parties):
(a) Recommendations (A/CN.9/637, recommendations 13-28) and (b) Commentary (A/CN.9/631/Add.1, paras. 142-247)

3. **Mr. Sigman** (United States of America), referring to subparagraph 6 (i) of document A/CN.9/XL/CRP.9/Add.1 concerning the commentary to chapter IV, proposed inserting the phrase "if one did not previously exist" after "agreement" to make it clear that a new written agreement would not be required if one already existed.

4. *It was so decided.*

5. **Ms. McCreath** (United Kingdom) referred to the text in square brackets following paragraph 16

of document A/CN.9/XL/CRP.9/Add.2, which stated that a new subparagraph 6 (vi) would be inserted in document A/CN.9/XL/CRP.9/Add.1 to the effect that paragraph 196 of the commentary should be revised to indicate that a floating charge was indeed a security right and that the difference between a floating charge should be briefly discussed. She requested that when paragraph 196 was revised, the word "so-called" before "floating charge" should also be deleted because of its negative connotation.

6. *It was so decided.*

7. **Mr. Weise** (Observer for the American Bar Association), referring to paragraph 6 (viii) concerning the reasons why anti-assignment clauses were invalidated with respect to the assignment of some types of receivables and not with respect to others, suggested replacing the word "upheld" by "not invalidated".

8. *It was so decided.*

9. *The section of the draft report on chapter IV, as amended, was adopted.*

2. Chapter V: Effectiveness of a security right against third parties: (a) Recommendations (A/CN.9/637, recommendations 29-53) and (b) Commentary (A/CN.9/631/Add.2)

10. *The section of the draft report on chapter V was adopted.*

3. Chapter VI: The registry system:
(a) Recommendations (A/CN.9/637, recommendations 54-72)

11. **Mr. Weise** (Observer for the American Bar Association) suggested inserting small roman numerals in paragraph 9 of document A/CN.9/XL/CRP.9/Add.1, which would then read:

"... it was noted that recommendation 57 required only the information necessary for third parties so as: (i) to avoid unnecessary

information that could confuse third parties or lead to errors that might invalidate notices; (ii) to standardize the information required; and (iii) to send the message that, unlike immovable property title registries, movable property security right registries required minimal information.”

12. *It was so decided.*

13. **Mr. Weise** (Observer for the American Bar Association) suggested amending the second sentence of paragraph 16 of document A/CN.9/XL/CRP.9/Add.1 to read: “...if the law prescribed a limited duration of registration (...), an erroneous statement would not affect the duration of the registration to the extent permitted by the law”.

14. *It was so decided.*

15. *Document A/CN.9/XL/CRP.9/Add.1, as amended, was adopted.*

Draft report on chapter VI (continued), the introductory chapter, and chapters I, II, X and XI (A/CN.9/XL/CRP.9/Add.2)

3. *Chapter VI: The registry system:*

(a) *Recommendations (A/CN.9/637, recommendations 54-72) (continued) and*
(b) *Commentary (A/CN.9/631/Add.3)*

16. **Mr. Weise** (Observer for the American Bar Association) suggested replacing the words “reliability of the registry” in the second sentence of paragraph 3 of document A/CN.9/XL/CRP.9/Add.2 by “effectiveness of the registry”.

17. **Ms. Walsh** (Canada) said that she interpreted the reference to reliability as referring to the reliability of the registry records from the point of view of a third-party searcher.

18. **Mr. Weise** (Observer for the American Bar Association) suggested referring in that case to the “ability to rely on a search of the registry”.

19. **Mr. Riffard** (France) proposed covering all eventualities by using the phrase “reliability and effectiveness of the registry”.

20. **Mr. Sigman** (United States of America) cautioned against introducing a casual reference to “effectiveness” in the draft report, since the term might be misinterpreted.

21. **The Chairperson** said that he took it that the Commission would prefer to leave the wording unchanged.

22. *It was so decided.*

23. **Mr. Weise** (Observer for the American Bar Association) suggested inserting the words “in effect” before “involved” in the third sentence of paragraph 6 of document A/CN.9/XL/CRP.9/Add.2 because the original grantor would retain its name but the new owner of the encumbered asset would, in effect, have become the grantor.

24. *It was so decided.*

25. *The section of the draft report on chapter VI, as amended, was adopted.*

4. *Reordering of the introduction, chapter I (Key objectives) and section C of chapter II (Scope of application and other general rules) (A/CN.9/631/Add.1, paras 1-12, 20-31 and 55-57; A/CN.9/637, paras. 1-6; A/CN.9/XL/CRP.11/Add.1))*

5. *Chapter II: Scope of application and other general rules; and chapter III: Basic approaches to security: (a) Recommendations (A/CN.9/637, recommendations 2-12) and (b) Commentary (A/CN.9/631/Add.1, paras. 23-56 and 78-141)*

26. **Mr. Macdonald** (Canada) proposed amending subparagraph 14 (iv) of document A/CN.9/XL/CRP.9/Add.2 to read: “Section D should include recommendations 2-12 from document A/CN.9/637 ordered in accordance with subparagraphs (i), (ii) and (iii).”

27. *It was so decided.*

28. *The section of the draft report on the reordering of the introduction, chapter I and section C of chapter II, and the section on chapter II, as amended, were adopted.*

6. *Chapter X: Enforcement of a security right: (a) Recommendations (A/CN.9/637, recommendations 128-173) and (b) Commentary (A/CN.9/637/Add.4)*

7. *Chapter XI: Acquisition financing: (a) Recommendations (A/CN.9/637,*

*recommendations 174-199) and
(b) Commentary (A/CN.9/631/Add.5)*

29. **The Chairperson** noted that document A/CN.9/XL/CRP.9/Add.2 contained only part of the draft report on chapter X.

30. *The section of the draft report on chapter XI was adopted.*

31. *Document A/CN.9/XL/CRP.9/Add.2, as amended, was adopted.*

Draft report on chapter X (continued), chapters XII to XIV and proposed amendments to the terminology and recommendations contained in document A/CN.9/XL/CRP.10 (A/CN.9/XL/CRP.9/Add.3)

32. *The section of the draft report on chapter X was adopted.*

*8. Chapter XII: Conflict of laws:
(a) Recommendations (A/CN.9/637,
recommendations 200-224) and
(b) Commentary (A/CN.9/631/Add.6)*

*9. Chapter XIII: Transition:
(a) Recommendations (A/CN.9/637,
recommendations 225-241) and
(b) Commentary (A/CN.9/631/Add.7)*

33. *The sections of the draft report on chapters XII and XIII were adopted.*

*10. Chapter XIV: Insolvency:
(a) Recommendations (A/CN.9/637,
recommendations 232-239) and
(b) Commentary (A/CN.9/631/Add.8)*

34. **Ms. McCreath** (United Kingdom) drew attention to paragraph 21 of document A/CN.9/XL/CRP.9/Add.3, which stated that it had been agreed that the commentary should explain that the term “financial contract” was defined in both the draft Guide and the UNCITRAL Legislative Guide on Insolvency Law in accordance with article 5 (k) of the United Nations Convention on the Assignment of Receivables in International Trade. She proposed specifying at the end of the paragraph that the definition in the draft Guide was contained in paragraph (s) of the “Terminology” section.

35. **The Chairperson** noted that it had been decided to remove the paragraph lettering before the

definitions. However, the location of the definition could no doubt be identified by some other means. If she heard no objection, she would take it that the Commission wished to adopt the proposed amendment.

36. *It was so decided.*

37. *The section of the draft report on chapter XIV, as amended, was adopted.*

11. Proposed amendments to the terminology and recommendations contained in document A/CN.9/XL/CRP.10

38. **Mr. Sigman** (United States of America) proposed inserting the phrase “effective against third parties and” after “took the asset subject to a security right” in the second sentence of paragraph 30 of document A/CN.9/XL/CRP.9/Add.3.

39. *It was so decided.*

40. *The section of the draft report dealing with proposed amendments to the terminology and recommendations contained in document A/CN.9/XL/CRP.10 was adopted.*

41. *Document A/CN.9/XL/CRP.9/Add.3, as amended, was adopted.*

The discussion covered in the summary record ended at 12.20 p.m.

**Summary record (partial) of the 864th meeting, held at the Vienna International Centre
on Friday, 14 December 2007, at 2 p.m.**

[A/CN.9/SR.864]

Chairperson: Ms. Sabo (Canada)

The meeting was called to order at 2.10 p.m.

Adoption of the report of the Commission
(continued)

Adoption of a draft UNCITRAL Legislative Guide on Secured Transactions (A/CN.9/XL/CRP.9/Add.1-4)
(continued)

Draft report on recommendation 205, the commentaries to chapters VII to IX and XII and the decision by the Commission to adopt the draft Guide (A/CN.9/XL/CRP.9/Add.4)

12. Recommendation 205

1. **The Chairperson** invited the Commission to resume its consideration of the draft report on the draft Guide. The first five paragraphs of document A/CN.9/XL/CRP.9/Add.4 dealt with the Commission's discussion of recommendation 205.

2. **Mr. Schöfisch** (Germany) proposed inserting the words "by a group of States" after "concern was expressed" in the first sentence of paragraph 1.

3. **Mr. Riffard** (France) said that the word "group" might be construed as referring to a structured grouping. He proposed instead inserting the words "by a number of States".

4. *It was so decided.*

5. **Mr. Bazinas** (Secretariat) suggested that, in light of the amendment just adopted, the last sentence of the paragraph should be replaced by the following three sentences:

"In order to address that concern, several suggestions were made. One was that recommendation 205 should be revised to provide more flexibility, indicating that there were other possible approaches (with the addition, for example, of the word 'primarily' after the words 'the law should ...'). Another was that the commentary should address the

merits of an approach based on the law governing the receivable."

6. **Ms. McCreath** (United Kingdom) proposed replacing the word "primarily" within brackets by the word "ordinarily".

7. **The Chairperson** said that, if she heard no objection, she would take it that the Commission wished to adopt the text suggested by the Secretariat as amended by the representative of the United Kingdom.

8. *It was so decided.*

9. **Mr. Weise** (Observer for the American Bar Association) suggested adding the words "that registers" after the words "the secured creditor (assignee)" in the penultimate sentence of paragraph 2.

10. **Mr. Bazinas** (Secretariat) pointed out that the second part of the sentence referred to meeting the requirements of third-party effectiveness because the secured creditor would not know whether registration was the mode of achieving third-party effectiveness in the jurisdiction of the grantor's new location. He therefore suggested inserting the words "that met the requirements for third-party effectiveness" instead of "that registers".

11. **The Chairperson** said she took it that the Commission wished to adopt the suggested amendment as revised by the Secretariat.

12. *It was so decided.*

13. **Mr. Smith** (United States of America) proposed inserting the words "in the commentary" after "elaboration" in the first sentence of paragraph 3.

14. *It was so decided.*

15. **Mr. Schöfisch** (Germany) proposed inserting the following two sentences before the last sentence of paragraph 3: "One delegation proposed deleting the sentences. Another delegation suggested that the commentary should provide a neutral explanation."

He further proposed replacing the phrase “In response, it was stated that” in the last sentence by “It was noted that”.

16. *It was so decided.*

17. **Mr. Weise** (Observer for the American Bar Association) suggested inserting the words “with respect to future receivables” at the end of the third sentence of paragraph 4.

18. **The Chairperson** said that, if she heard no objection, she would take it that the Commission wished to adopt the suggested amendment.

19. *It was so decided.*

20. **Ms. McCreath** (United Kingdom) proposed amending the opening phrase of the first sentence of paragraph 5, which currently stated that, after discussion, “the Commission decided that recommendation 205 should remain unchanged”, to read: “the Commission decided that recommendation 205 could not be changed at such a late stage”.

21. **Mr. Burman** (United States of America) said that there had clearly been no consensus on the proposed amendment to recommendation 205. It would therefore be inaccurate to give the impression that the Commission had decided not to act on a consensus because the recommendation had already been adopted.

22. **Mr. Ghia** (Italy) expressed support for the amendment proposed by the delegation of the United Kingdom.

23. **The Chairperson** pointed out that the reasoning that had led to the Commission’s decision was set out in paragraphs 3 and 4.

24. **Mr. Bazinas** (Secretariat) said that paragraph 3 described the broad support that had been expressed for further elaboration in the commentary of the approach based on the law governing the receivable. Paragraph 4 set out the reasons invoked by those who had opposed any amendment to the recommendation, for instance the fact that it had already been adopted and that it was consistent with the rule contained in the United Nations Convention on the Assignment of Receivables in International Trade, as well as other substantive arguments.

25. **Mr. Schöfisch** (Germany) said that, in his view, a broad majority had been in favour of revising recommendation 205, since almost all European Union member States had expressed support for the amendment proposed by the delegation of the United Kingdom. Although the Chairperson’s ruling against any change had been accepted, there had been no agreement that the rule laid down in recommendation 205 was sound. He therefore supported the amendment to the draft report proposed by the representative of the United Kingdom.

26. **Mr. Riffard** (France) pointed out that the Commission had decided against reopening the debate on recommendation 205 and against amending it because there was no consensus on such action. Indeed several delegations had raised formal objections to any amendment.

27. **Ms. McCreath** (United Kingdom) said that, in her view, there had been a broad consensus in favour of change. However, she would accept alternative wording that explained in greater detail why the recommendation had been left unchanged.

28. **Mr. Pinto Ribeiro** (Observer for Portugal) said that he concurred with the representative of Germany. He suggested amending the opening phrase of paragraph 5 to read: “After discussion, it was decided that no consensus had been reached by the Commission on reopening the discussion on recommendation 205.”

29. **Mr. Burman** (United States of America) and **Mr. Patch** (Australia) said that they were willing to support the amendment suggested by the observer for Portugal.

30. **Mr. Schöfisch** (Germany) and **Ms. McCreath** (United Kingdom) expressed a preference for the following wording: “After discussion, it was decided that recommendation 205 should not be reopened for discussion.”

31. **Mr. Pinto Ribeiro** (Observer for Portugal) said that he could also support that proposal.

32. **Mr. Marca Paco** (Bolivia) pointed out that a number of delegations had in fact reopened the debate on recommendation 205. In his view, the first sentence of paragraph 5 should remain unchanged.

33. **Mr. Burman** (United States of America) expressed support for the wording proposed by the representatives of Germany and the United Kingdom.

34. **The Chairperson** said that, if she heard no objection, she would take it that the Commission agreed to adopt the amendment proposed by the representatives of Germany and the United Kingdom.

35. *It was so decided.*

36. *The section of the draft report on recommendation 205, as amended, was adopted.*

13. Commentaries to chapters VII to IX and XII

37. *The section of the draft report on the commentaries to chapters VII to IX and XII was adopted.*

14. Decision by the Commission to adopt the draft Guide

38. **Mr. Schöfisch** (Germany) proposed adding a preambular paragraph expressing the Commission's appreciation of the work of the Chairperson and the Secretariat.

39. *It was so decided.*

40. *The section of the draft report on the decision by the Commission to adopt the draft Guide, as amended, was adopted.*

41. *Document A/CN.9/XL/CRP.9/Add.4, as amended, was adopted.*

42. *The portion of the Commission's report on the adoption of a draft UNCITRAL Legislative Guide on Secured Transactions, as a whole, as amended, was adopted.*

The discussion covered in the summary record ended at 2.55 p.m.

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XI. International countertrade

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XII. Privately financed infrastructure projects

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Annex

UNCITRAL legal texts

<i>Short title</i>	<i>Full title</i>
Hamburg Rules (1978)	United Nations Convention on the Carriage of Goods by Sea, 1978 (Hamburg) ^a
Limitation Convention (1974/1980)	Convention on the Limitation Period in the International Sale of Goods, 1974 (New York), ^b and Protocol amending the Convention on the Limitation Period in the International Sale of Goods, 1980 (Vienna) ^c
UNCITRAL Arbitral Proceedings Notes (1996)	UNCITRAL Notes on Organizing Arbitral Proceedings (1996) ^d
UNCITRAL Arbitration Rules (1976)	UNCITRAL Arbitration Rules (1976) ^e
UNCITRAL Bills and Notes Convention (1988)	United Nations Convention on International Bills of Exchange and International Promissory Notes (1988) ^f
UNCITRAL Conciliation Rules (1980)	UNCITRAL Conciliation Rules (1980) ^g
UNCITRAL Construction Contracts Guide (1987)	UNCITRAL Legal Guide on Drawing Up International Contracts for the Construction of Industrial Works (1987) ^h
UNCITRAL Credit Transfer Model Law (1992)	UNCITRAL Model Law on International Credit Transfers (1992) ⁱ
UNCITRAL Electronic Funds Guide (1986)	UNCITRAL Legal Guide on Electronic Funds Transfers (1986) ^j
UNCITRAL Infrastructure Projects Guide (2001)	UNCITRAL Legislative Guide on Privately Financed Infrastructure Projects (2001) ^k
UNCITRAL Insolvency Law Guide (2004)	UNCITRAL Legislative Guide on Insolvency Law (2004) ^l
UNCITRAL International Countertrade Guide (1992)	UNCITRAL Legal Guide on International Countertrade Transactions (1992) ^m
UNCITRAL Model Arbitration Law (1985)	UNCITRAL Model Law on International Commercial Arbitration (1985) ⁿ
UNCITRAL Model Conciliation Law (2002)	UNCITRAL Model Law on International Commercial Conciliation (2002) ^o
UNCITRAL Model Insolvency Law (1997)	UNCITRAL Model Law on Cross-Border Insolvency (1997) ^p
UNCITRAL Model Law on Electronic Commerce (1996)	UNCITRAL Model Law on Electronic Commerce (1996) ^q
UNCITRAL Model Law on Electronic Signatures (2001)	UNCITRAL Model Law on Electronic Signatures (2001) ^r
UNCITRAL Model Procurement Law (1994)	UNCITRAL Model Law on Procurement Of Goods, Construction and Services (1994) ^s
UNCITRAL Model Provisions on Infrastructure Projects (2003)	UNCITRAL Model Legislative Provisions on Privately Financed Infrastructure Projects (2003) ^t
United Nations Assignment Convention (2001)	United Nations Convention on the Assignment of Receivables in International Trade (2001) ^u

<i>Short title</i>	<i>Full title</i>
United Nations Convention on Electronic Contracting (2005)	United Nations Convention on the Use of Electronic Communications in International Contracts (2005) ^v
United Nations Guarantee and Stand-by Convention (1995)	United Nations Convention on Independent Guarantees and Stand-by Letters of Credit (1995) ^w
United Nations Sales Convention (1980)	United Nations Convention on Contracts for the International Sale of Goods (1980) ^x
United Nations Terminal Operators Convention (1991)	United Nations Convention on the Liability of Operators of Transport Terminals in International Trade (1991) ^y

Notes

- ^a United Nations publication, Sales No. E.95.V.14.
- ^b Official Records of the United Nations Conference on Prescription (Limitation) in the International Sale of Goods, New York, 20 May-14 June 1974 (United Nations publication, Sales No. E.74.V.8), part I.
- ^c Official Records of the United Nations Conference on Contracts for the International Sale of Goods, Vienna, 10 March-11 April 1980 (United Nations publication, Sales No. E.81.IV.3), part I.
- ^d Official Records of the General Assembly, Fifty-first Session, Supplement No. 17 (A/51/17), part II.
- ^e United Nations publication, Sales No. E.93.V.6.
- ^f United Nations publication, Sales No. E.95.V.16.
- ^g United Nations publication, Sales No. E.81.V.6.
- ^h United Nations publication, Sales No. E.87.V.10.
- ⁱ United Nations publication, Sales No. E.99.V.11.
- ^j United Nations publication, Sales No. E.87.V.9.
- ^k United Nations publication, Sales No. E.01.V.4.
- ^l United Nations publication, Sales No. E.05.V.10.
- ^m United Nations publication, Sales No. E.93.V.7.
- ⁿ United Nations publication, Sales No. E.95.V.18.
- ^o United Nations publication, Sales No. E.05.V.4.
- ^p United Nations publication, Sales No. E.99.V.3.
- ^q United Nations publication, Sales No. E.99.V.4.
- ^r United Nations publication, Sales No. E.02.V.8.
- ^s United Nations publication, Sales No. E.98.V.13.
- ^t United Nations publication, Sales No. E.04.V.11.
- ^u United Nations publication, Sales No. E.04.V.14.
- ^v United Nations publication, Sales No. E.07.V.02.
- ^w United Nations publication, Sales No. E.97.V.12.
- ^x United Nations publication, Sales No. E.95.V.12.
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III. CHECK-LIST OF DOCUMENTS OF THE UNITED NATIONS COMMISSION ON INTERNATIONAL TRADE LAW

<i>Document Symbol</i>	<i>Title or description</i>	<i>Location in Present volume</i>
A. List of documents before the Commission at its fortieth session		
1. General series		
A/CN.9/613	Provisional agenda, annotations thereto and scheduling of meetings of the fortieth session	Not reproduced
A/CN.9/614	Report of Working Group II (Arbitration and Conciliation) on the work of its forty-fifth session (Vienna, 11-15 September 2006)	Part two, chap. III, A
A/CN.9/615	Report of Working Group I (Procurement) on the work of its tenth session (Vienna, 25-29 September 2006)	Part two, chap. II, A
A/CN.9/616	Report of Working Group III (Transport Law) on the work of its eighteenth session (Vienna, 6-17 November 2006)	Part two, chap. IV, A
A/CN.9/617	Report of Working Group VI (Security Interests) on the work of its eleventh session (Vienna, 4-8 December 2006)	Part two, chap. I, A
A/CN.9/618	Report of Working Group V (Insolvency Law) on the work of its thirty-first session (Vienna, 11-15 December 2006)	Part two, chap. V, A
A/CN.9/619	Report of the Working Group on Arbitration and Conciliation on the work of its forty-sixth session (New York, 5-9 February 2007)	Part two, chap. III, C
A/CN.9/620	Report of Working Group VI (Security Interests) on the work of its twelfth session (New York, 12-16 February 2007)	Part two, chap. I, C
A/CN.9/621	Report of Working Group III (Transport Law) on the work of its nineteenth session (New York, 16-27 April 2007)	Part two, chap. IV, J
A/CN.9/622	Report of Working Group V (Insolvency Law) on the work of its thirty-second session (New York, 14-18 May 2007)	Part two, chap. V, C
A/CN.9/623	Report of Working Group I (Procurement) on the work of its eleventh session (New York, 21-25 May 2007)	Part two, chap. II, D
A/CN.9/624 and Add.1-2	Note by the Secretariat on Indicators of Commercial Fraud	Part two, chap. VI, C

<i>Document Symbol</i>	<i>Title or description</i>	<i>Location in Present volume</i>
A/CN.9/625	Note by the Secretariat on a bibliography of recent writings related to the work of UNCITRAL	Part three, chap. II
A/CN.9/626	Note by the Secretariat on the status of conventions and model laws	Part two, chap. IX
A/CN.9/627	Note by the Secretariat on Technical cooperation and assistance	Part two, chap. VIII
A/CN.9/628 and Add.1	Note by the Secretariat on Current activities of international organizations related to the harmonization and unification of international trade law	Part two, chap. X
A/CN.9/629	Facilitation of cooperation, direct communication and coordination in cross-border insolvency proceedings	Not reproduced
A/CN.9/630 and Add.1-5	Note by the Secretariat on possible future work on electronic commerce – Comprehensive reference document on elements required to establish a favourable legal framework for electronic commerce: sample chapter on international use of electronic authentication and signature methods	Part two, chap. VI, B
A/CN.9/631 and Add.1-11	Note by the Secretariat on Recommendations of the UNCITRAL draft Legislative Guide on Secured Transactions	Part two, chap. I, E
A/CN.9/632	Note by the Secretariat on possible future work on security rights in intellectual property	Part two, chap. VI, A
A/CN.9/633	Note by the Secretariat on comments of the European Community and its member States on the Draft legislative guide on secured transactions	Not reproduced
A/CN.9/634	Report of the Secretary-General of the Permanent Court of Arbitration on its activities under the UNCITRAL Arbitration Rules since 1976	Part two, chap. III, E
A/CN.9/635	Note by the Secretariat on France's observations on UNCITRAL's working methods	Not reproduced
A/CN.9/636	Provisional agenda, annotations thereto and scheduling of meetings of the resumed fortieth session	Not reproduced
A/CN.9/637 and Add.1-8	Note by the Secretariat on terminology and recommendations of the UNCITRAL draft legislative guide on secured transactions	Part two, chap. I, F
A/CN.9/638 and Add.1-6	Note by the Secretariat on UNCITRAL rules of procedure and methods of work	Not reproduced
A/CN.9/639	Note by the Secretariat on UNCITRAL rules of procedure and methods of work – Observations by the United States	Not reproduced
2. Restricted series		
A/CN.9/XL/CRP.1 and Add.1-21	Draft report of the United Nations Commission on International Trade Law on the work of its fortieth session	Not reproduced

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A/CN.9/XL/CRP.4	Note by the Secretariat on comments by the International Institute for the Unification of Private Law (UNIDROIT)	Not reproduced
A/CN.9/XL/CRP.5	Proposal by the Commercial Finance Association on the draft legislative guide on secured transactions: Security rights in certain non-intermediated securities	Not reproduced
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A/CN.9/XL/CRP.7	Proposal by the Canadian delegation on acquisition financing on the draft legislative guide on secured transactions: Security rights in certain non-intermediated securities	Not reproduced
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A/CN.9/WG.VI/WP.29	Note by the Secretariat on the draft legislative guide on secured transactions: terminology and recommendations, submitted to the Working Group on Security Interests at its eleventh session	Part two, chap. I, B

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A/CN.9/WG.VI/XI/CRP.1 and Add.1-4	Draft report of the Working Group on Security Interests at its eleventh session.	Not reproduced
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1. Working papers		
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A/CN.9/WG.I/WP.50	Note by the Secretariat on revisions to the UNCITRAL Model Law on Procurement of Goods, Construction and Services – drafting materials addressing the use of electronic communications in public procurement, publication of procurement-related information, and abnormally low tenders, submitted to the Working Group on Procurement at its eleventh session	Part two, chap. II, E
A/CN.9/WG.I/WP.51	Note by the Secretariat on revisions to the UNCITRAL Model Law on Procurement of Goods, Construction and Services – drafting materials for the use of electronic reverse auctions in public procurement, submitted to the Working Group on Procurement at its eleventh session	Part two, chap. II, F
A/CN.9/WG.I/WP.51 and Add.1	Note by the Secretariat on possible revisions to the UNCITRAL Model Law on Procurement of Goods, Construction and Services – drafting materials for the use of framework agreements and dynamic purchasing systems in public procurement, submitted to the Working Group on Procurement at its eleventh session	Part two, chap. II, G

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A/CN.9/WG.II/WP.143 and Add.1	Note by the Secretariat on settlement of commercial disputes: Revision of the UNCITRAL Arbitration Rules, submitted to the Working Group on Arbitration at its forty-fifth session	Part two, chap. III, B
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A/CN.9/WG.II/WP.145 and Add.1	Note by the Secretariat on settlement of commercial disputes: Revision of the UNCITRAL Arbitration Rules, submitted to the Working Group on Arbitration at its forty-sixth session	Part two, chap. III, D
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1. Working papers		
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A/CN.9/WG.III/WP.74	Note by the Secretariat on the preparation of a draft convention on the carriage of goods [wholly or partly] [by sea] – Shipper's liability for delay: Document presented for the information of the Working Group by the Government of Sweden, submitted to the Working Group on Transport Law at its eighteenth session	Part two, chap. IV, D
A/CN.9/WG.III/WP.75	Note by the Secretariat on the preparation of a draft convention on the carriage of goods [wholly or partly] [by sea] – Chapter 16: Jurisdiction, submitted to the Working Group on Transport Law at its eighteenth session	Part two, chap. IV, E
A/CN.9/WG.III/WP.76	Note by the Secretariat on the preparation of a draft convention on the carriage of goods [wholly or partly] [by sea] – Rights of suit and time for suit: document presented for information by the Government of Japan, submitted to the Working Group on Transport Law at its eighteenth session	Part two, chap. IV, F
A/CN.9/WG.III/WP.77	Note by the Secretariat on the preparation of a draft convention on the carriage of goods [wholly or partly] [by sea] – Procedure for amendment of limitation amounts – drafting proposal by the Government of the United States of America, submitted to the Working Group on Transport Law at its eighteenth session	Part two, chap. IV, G
A/CN.9/WG.III/WP.78	Note by the Secretariat on the preparation of a draft convention on the carriage of goods [wholly or partly] [by sea] – Relation with other conventions, submitted to the Working Group on Transport Law at its eighteenth session	Part two, chap. IV, H
A/CN.9/WG.III/WP.79	Note by the Secretariat on the preparation of a draft convention on the carriage of goods [wholly or partly] [by sea] – Identify of Carrier – Drafting proposal by the Governments of Italy and the Netherlands, submitted to the Working Group on Transport Law at its eighteenth session	Part two, chap. IV, I
2. Restricted series		
A/CN.9/WG.III/XVIII/CRP.1 and Add.1-16	Draft report of Working Group III (Transport Law) on the work of its eighteenth session	Not reproduced
A/CN.9/WG.III/XVIII/CRP.2	Preparation of a draft instrument on the carriage of goods [wholly or partly][by sea]. Joint proposal of the delegations of	Not reproduced

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	Italy and the Netherlands for the text of draft article 43	
A/CN.9/WG.III/XVIII/CRP.3	Preparation of a draft instrument on the carriage of goods [wholly or partly][by sea]	Not reproduced
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H. List of documents before the Working Group on Transport Law at its nineteenth session		
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A/CN.9/WG.III/WP.81 and Corr.1	Note by the Secretariat on the draft convention on the carriage of goods [wholly or partly] [by sea], submitted to the Working Group on Transport Law at its nineteenth session	Part two, chap. IV, K
A/CN.9/WG.III/WP.82	Note by the Secretariat on the preparation of a draft convention on the carriage of goods [wholly or partly] [by sea] – Position of the French National Committee of the International Chamber of Commerce (ICC France), submitted to the Working Group on Transport Law at its nineteenth session	Part two, chap. IV, L
A/CN.9/WG.III/WP.83	Note by the Secretariat on the preparation of a draft convention on the carriage of goods [wholly or partly] [by sea] – Position of the European Shippers' Council, submitted to the Working Group on Transport Law at its nineteenth session	Part two, chap. IV, M
A/CN.9/WG.III/WP.84	Note by the Secretariat on the preparation of a draft convention on the carriage of goods [wholly or partly] [by sea] – Proposal of the United States of America on the definition of "maritime performing party", submitted to the Working Group on Transport Law at its nineteenth session	Part two, chap. IV, N
A/CN.9/WG.III/WP.85	Note by the Secretariat on the preparation of a draft convention on the carriage of goods [wholly or partly] [by sea] – Shipper's Obligations: Drafting proposal by the Swedish delegation, submitted to the Working Group on Transport Law at its nineteenth session	Part two, chap. IV, O
A/CN.9/WG.III/WP.86	Note by the Secretariat on the preparation of a draft convention on the carriage of goods [wholly or partly] [by sea] – Proposal of the delegations of Denmark, Norway and Finland on draft article 37 (1)(a) regarding contract particulars, submitted to the Working Group on Transport Law at its nineteenth session	Part two, chap. IV, P

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IV. LIST OF DOCUMENTS OF THE UNITED NATIONS COMMISSION ON INTERNATIONAL TRADE LAW REPRODUCED IN PREVIOUS VOLUMES OF THE *YEARBOOK*

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 - (f) Working Group VI:
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* For its 23rd session (Vienna, 11-22 December 2000), this Working Group was named Working Group on International Contract Practices (see the report of the Commission on its 33rd session A/55/17, para.186).

** At its 35th session, the Commission adopted one-week sessions, creating six working groups.

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